Global Macro Research

Top of Mind

October 18, 2016

Issue 51

US Presidential Prospects

From the editor: With November 8 in sight, the US presidential election is Top of Mind. We ask noted forecaster Larry Sabato about his predictions (a Clinton win is likely, a Democratic sweep is not) and if we should doubt the polls (no). Alec Phillips compares the candidates' proposals, which amount to more regulation, higher taxes, greater certainty on monetary policy, and somewhat friendlier trade policy under Clinton. He flags potential for increased infrastructure spending under either candidate, although in the base case of divided government, even that is not a done deal. We interview Brookings fellow Jonathan Rauch about his controversial view that political reforms are to blame for dysfunction in Washington. And we explore asset implications of election outcomes, with the S&P 500 and MXN seeming to prefer Clinton, though US equities may react less favorably to a Democratic sweep (a notable risk for the healthcare sector).

Source: www.istockphoto.com.

Inside

"If there are hidden Trump voters, you would expect them to be more forthcoming in an anonymous online poll than in a live interview. But I've looked carefully at the data, and at most there is about a one percentage point difference between online polls and live phone polls."

Larry Sabato

"Under the base case of divided government, Congress and the White House are likely to struggle to enact significant legislation, in light of partisan discord and the likelihood of slim majorities in both chambers of Congress... In such a scenario, we would expect to meet deadlines... but not much more."

Alec Phillips

"[Our system that enabled things done in government] did not commit suicide or die of old age. We reformed it to death. We made a series of deliberate choices over the last 40 or 50 years that have systematically weakened organizing institutions and politics."

Jonathan Rauch

Editors: Allison Nathan | allison.nathan@gs.com | Marina Grushin | marina.grushin@gs.com
Macro Executive Committee: Jeffrey Currie | Jan Hatzius | Kathy Matsui | Timothy Moe | Peter Oppenheimer

Macro news and views

We provide a brief snapshot on the most important economies for the global markets

US

Latest GS proprietary datapoints/major changes in views

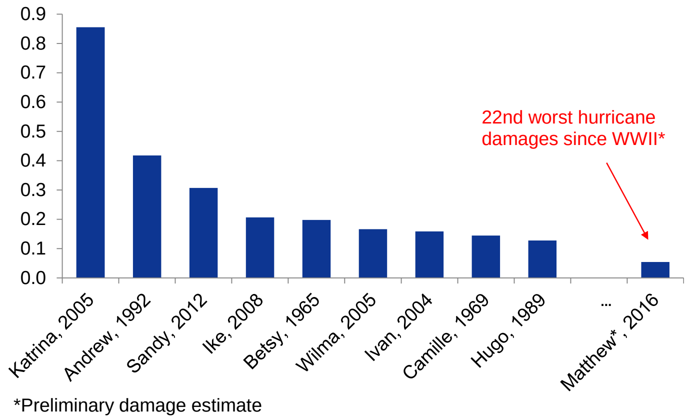
- We raised our subjective odds of a rate hike this year to 75% from 65%, reflecting better growth data and higher odds of a Clinton victory in the election (as markets seem to think a Trump victory could cause financial conditions to tighten).

Datapoints/trends we're focused on

- Debate over delaying hikes until inflation is at/very close to 2% or running a "high-pressure economy" in coming years.
- The effects of Hurricane Matthew, which could weigh on employment and IP in the weeks ahead, albeit temporarily.

Matthew in at #22

Hurricane-related property damages as a % of US GDP



Source: National Hurricane Center, Goldman Sachs Global Investment Research.

Japan

Latest GS proprietary datapoints/major changes in views

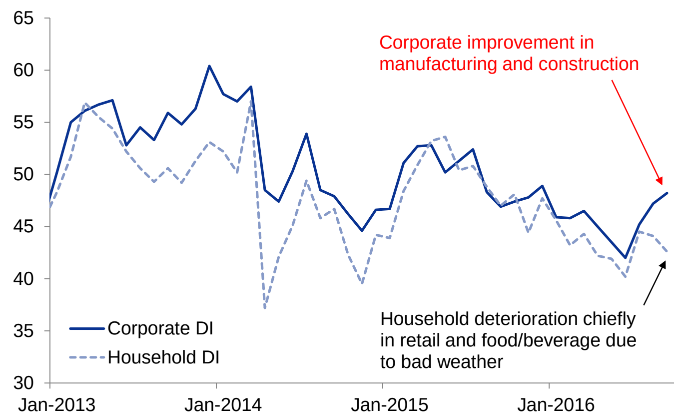
- No major changes in views.

Datapoints/trends we're focused on

- Corporate goods prices leveling off for the first time in four months, though they remain on a downward trend yoy.
- The third straight improvement in the corporate activity DI, though some survey respondents raised concerns about a decline in manufacturing orders due to the strong yen.
- A sharp slowdown in Japanese investors' net purchases of foreign securities, potentially due to quarter-end.

Diverging DIs

Diffusion Indices (DIs) from Japan Economy Watchers Survey



Source: Japan Cabinet Office, Haver Analytics.

UK and Euro Area (EA)

Latest GS proprietary datapoints/major changes in views

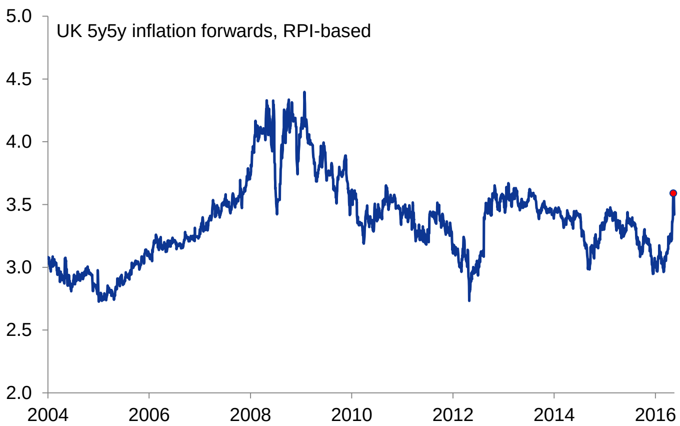
- We now expect a 15bp rate cut by the BOE in February rather than November, reflecting sharp sterling depreciation on fears of a "hard Brexit," the related rise in break-even inflation, and somewhat better-than-expected activity data.

Datapoints/trends we're focused on

- The risk of foreign investors losing confidence in the UK if UK-EU politics become confrontational, which could limit scope for BOE easing if inflation expectations de-anchor.
- Robust rebounds in EA IP, a positive sign for Q3 growth.

Eying inflation forwards

Market expectations for UK 5-year inflation 5 years from now, %



Source: FactSet, Goldman Sachs Global Investment Research.

Emerging Markets (EM)

Latest GS proprietary datapoints/major changes in views

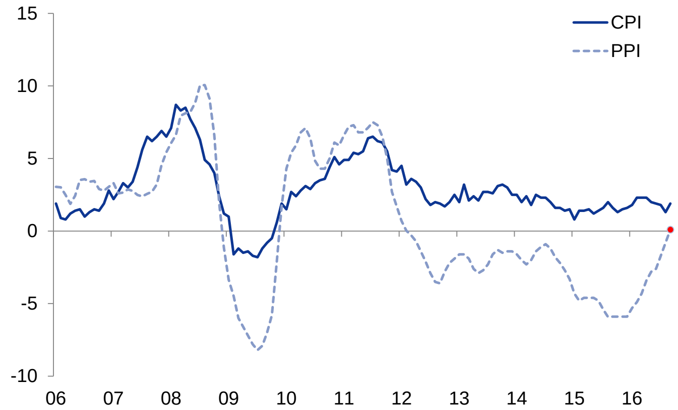
- No major changes in views.

Datapoints/trends we're focused on

- Better-than-expected September inflation in China, including the first positive PPI print yoy since 2012; since overall inflation remains mild, we expect policy to stay supportive.
- Weak September trade data from China, with exports down 10% yoy vs. -5% expected, putting pressure on the RMB.
- Downside inflation surprises in Brazil, informing our expectation for the central bank to start easing this week.

(Barely) positive PPI

China consumer and producer price indices, % yoy



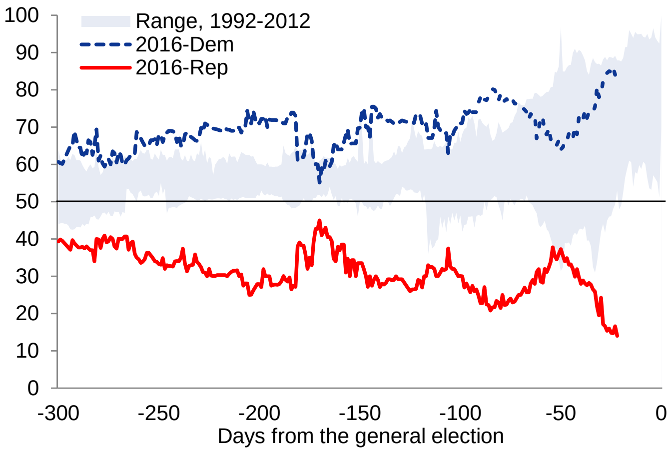
Source: China NBS, Haver Analytics.

US presidential prospects

With November 8 within our sights, let's cut straight to the chase: The US presidential election is Top of Mind.

Looking ahead to November 8

Implied probability for eventual winning party, %



As of October 17, 2016. Source: Iowa Electronic Markets, University of Iowa; compiled by Goldman Sachs Global Investment Research.

We kick off with an update on the horserace itself by sitting down with Larry Sabato, the founder and director of the University of Virginia's Center for Politics, who has accurately forecasted 98% of the races for president, Congress, and governor since 2000. Sabato remains very confident in his prediction that Clinton will take the presidency, arguing that Trump could only win if he increased his share of the white electorate (difficult, when Clinton is leading with college-educated white voters by an 8pp margin) *and* substantially increased the white share of the overall electorate (all but impossible, in Sabato's opinion). But despite increased market focus on the potential for a Democratic "sweep" of the presidency and both chambers of Congress, he thinks the House is likely to remain under Republican control. And as for the widespread concerns that polls are just less reliable in this unpredictable year? Sabato doesn't buy it, and finds that any Trump supporters hesitating to voice their voting preferences only amount to a percentage or two of the vote—far from enough to overcome Clinton's current margin.

We then turn to GS Senior Political Economist Alec Phillips to assess the economic implications of various election outcomes. Phillips compares the candidates' proposals, which amount to more regulation, higher taxes, greater certainty on monetary policy certainty, and somewhat friendlier trade policy in a Clinton vs. a Trump scenario. While fiscal policy should become more expansionary in our base-case scenario—Clinton and a divided Congress—Phillips thinks the boost would be modest, giving only ~50% odds for a bipartisan deal on Clinton's infrastructure program. Interestingly, he points out that a Democratic sweep may not improve the prospects for fiscal stimulus, since it would raise the odds of pushing through material tax increases that would largely offset Clinton's spending proposals. But given Phillips's expectation for divided government, the most likely outcome might just be continued legislative gridlock.

This likelihood underscores the discord in Congress that existed long before this tumultuous election year—something that Jonathan Rauch, Senior Fellow at the Brookings Institution, explored in "How American Politics Went Insane," an article recently featured in *The Atlantic*. Rauch argues that heightened dysfunction in Washington in recent years is the result of decades of reforms to US political processes that have stripped politicians of the tools they need to govern. In short, political favors, middlemen, and smoke-filled rooms were perhaps unseemly, but they got things done by enabling frank negotiations and creating incentives for compromise. Without them, political "chaos" has ensued. In his view, Clinton's approach to politics that embraces coalition-building gives her a decent shot at effective governing should she get elected, while Trump's opposite approach does not.

So what might the election mean for markets? As Alec Phillips notes, increases in the probability of a Clinton win in prediction markets have been associated with rises in US equities and appreciation of the Mexican peso and Canadian dollar. However, US equities seem to react negatively to higher odds of a Democratic sweep—suggesting that Phillips's base case may also be the best case for risk assets.

For those worried about alternative scenarios, GS Senior Portfolio Strategist Ben Snider offers some comfort by pointing out that six months post-election, the S&P 500 has risen nearly two-thirds of the time by a median of +3%. Heading into November 8, he recommends owning exposure to policy outcomes that are likely under either candidate, namely, increased government spending, corporate tax reform, and potentially more inward leanings in terms of international trade (see pg. 10 for basket recommendations). He notes that the candidates differ most on policies that might affect stocks in the healthcare, energy, and financial services sectors.

GS Healthcare Sector Specialist Asad Haider then dives into the potential implications for his sector—an area where the candidates' views diverge substantially, with Clinton calling for an expansion of the Affordable Care Act (ACA) and Trump calling for its abolition. Despite these differences, Haider underscores that the most likely election outcome of divided government substantially reduces the likelihood of major reform. That said, he expects continued pricing scrutiny no matter who gets elected, which could lead to increased "self-regulation" from the biopharma industry. Additionally, he notes that increasing financial stress ACA exchanges could force legislators to act. A Democratic sweep represents a key risk across the entire healthcare sector, though some subsectors like health providers could benefit.

Finally, GS Emerging Markets Macro Strategist Mark Ozerov looks at the macro asset with perhaps the most exposure to this election given Trump's trade rhetoric: the Mexican peso. Even accounting for major global factors influencing the currency, he finds that a 1pp increase in the probability of Trump winning maps to about 0.3pp of MXN underperformance. This relationship suggests that the MXN could rally 4-5% from here on a Clinton victory, all else equal.

Allison Nathan, Editor

Email: allison.nathan@gs.com
Tel: 212-357-7504
Goldman, Sachs & Co.

Presidential policy: What's in store?

Alec Phillips walks through election implications for four key policy areas and concludes that a Clinton presidency and divided Congress—his base case—appears to be the most favorable outcome for risk assets

Over the last year, prediction markets and electoral models have implied that the most likely election outcome is a Hillary Clinton win with a divided government. However, over the last two weeks market participants appear to have shifted their assessment of the risks to this view, with a greater focus on the possibility of a Democratic sweep and a reduced focus on the possibility that Donald Trump wins with a Republican Congress.

Each of these outcomes would have very different policy implications. Under the base case of divided government, Congress and the White House are likely to struggle to enact significant legislation, in light of partisan discord and the likelihood of slim majorities in both chambers of Congress. In such a scenario, we would expect to meet deadlines—for example, a new spending agreement will need to be reached by September 30, 2017, and the debt limit is likely to need to be raised by October—but not much more.

By contrast, under single-party control, there would be two important differences. First, one party would set the legislative agenda and focus public attention on certain issues. Second, some decisions could be made with a simple majority. This means that the majority party could approve most nominations (except for the Supreme Court) and most fiscal legislation without support from the minority party, suggesting that much more could be accomplished, although not necessarily to the liking of markets, which seem wary of a Democratic sweep.

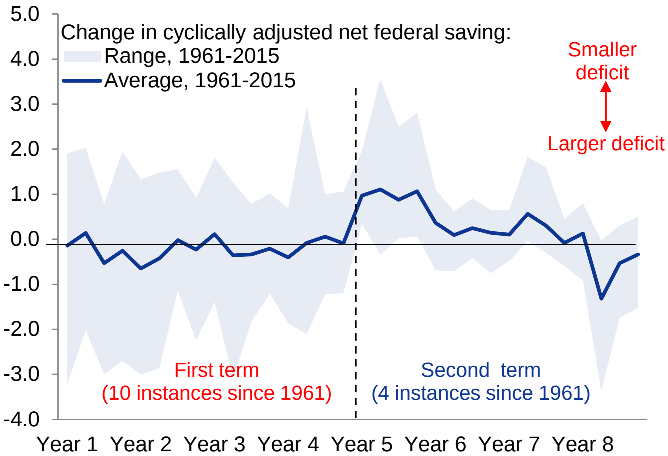
Easier post-election fiscal policy?

Fiscal policy has become slightly more expansionary, on average, early in new presidential terms, and we expect this pattern to continue over the next couple of years. However, under divided government the shift would be modest. If elected, we would expect Clinton to pursue her plan to boost infrastructure spending by $250bn over the next five years, financed by international corporate tax reform (including profit repatriation). Since this would require a bipartisan deal on how much to spend as well as a new system for taxing overseas earnings, we believe the odds of reaching such an agreement under divided government are only around 50%.

Under single-party control, the range of potential fiscal outcomes would broaden, primarily because the party in power would be able to use the budget "reconciliation" process to pass significant fiscal policy changes. This process allows tax and some spending legislation to be considered as part of the annual budget process and to pass the House and Senate with a simple majority, rather than the 60 votes usually required for Senate approval. The upshot is that if either party controls Congress and the White House, much more of their policy agenda could be enacted than under the divided government base case.

New administrations, new spending

Change in cyclically adjusted net federal saving, % of GDP, yr. ago



Source: Congressional Budget Office, Department of Commerce, Goldman Sachs Global Investment Research.

If Trump wins and the Republican House majority holds, we would expect fiscal policy to be looser than under the base case, for two reasons. First, we expect that a Republican Congress would be more likely to enact tax reform that results in net tax reduction, at least in the short term, than under divided government. Second, although he has not highlighted the issue the way that Clinton has, we expect that Trump would also support higher infrastructure spending.

Under Clinton and a Democratic Congress, it is less clear how the fiscal stance might change. While she proposes significant new spending, particularly on education and other social programs, her plans also call for material tax increases, mainly on high-income earners, large estates, and capital gains. The overall effect of her formal proposals would be roughly budget-neutral, according to external estimates.

However, even under single-party control, there would be some constraints on what legislators could accomplish on fiscal policy through the reconciliation process. Existing budget rules prohibit using the process to add to the deficit over ten years, though it is possible that the majority party could change these rules. More importantly, whichever party controls Congress would have a very slim majority, likely leaving legislators somewhat constrained. For example, several Senate Democrats face reelection in Republican-leaning states in 2018, and might be wary of supporting some of Clinton's initiatives.

Uncertainty on trade policy under any outcome

Trump's positions on international trade have been a focus for financial markets, as they diverge further from current policy than any candidate's in recent memory. By contrast, Clinton has expressed a view similar to President Obama's when he was running for president in 2008. Trump and Clinton both oppose the proposed Trans-Pacific Partnership (TPP), advocate renegotiating North American Free Trade Agreement (NAFTA), and have expressed concern about trade relations with China, but Trump goes further by urging new tariffs on imports from China and Mexico. Moreover, his skepticism of international trade appears to be a long-held view that has become a key focus of the campaign, suggesting Trump would likely come under political pressure to follow through on at least some of his commitments if elected. We also note that the president has significant discretion over trade policy; he or she could withdraw from NAFTA and other trade agreements and potentially impose tariffs on certain imports without congressional approval.

The risks from trade policy appear much greater under Trump, but there would be some uncertainty under Clinton as well. Her stated opposition to the terms of the TPP agreement reduces the chances of passage in the next couple of years since changes to the current agreement would probably need to be negotiated. Moreover, views in both political parties regarding trade policy are changing. Most Republican lawmakers support free trade agreements, but polling suggests the majority of Republican voters no longer do. Many Democratic lawmakers have been skeptical of trade agreements, but the majority of their constituents now appear to support them. This could result in an eventual realignment of trade views between the parties, but in the meantime suggests that passing TPP or other agreements would be difficult in any electoral scenario.

Greater monetary policy uncertainty under Trump

The winner of the presidential election will need to nominate the next Fed chair, as Chair Yellen's term expires in February 2018. In our view, Clinton would be likely to nominate Yellen for another term. There is much more uncertainty regarding who Trump might nominate, though he has made it clear he would not re-nominate Chair Yellen. His criticisms of Fed policy are somewhat ambiguous; he has suggested rates have been left too low for too long, but also warns of negative consequences of rate hikes. We would expect that financial markets would view a Trump victory as having slightly hawkish implications, since it would make a change in what many view as a dovish-leaning Fed leadership much more likely.

Regulatory and sector-related differences follow mostly traditional partisan lines

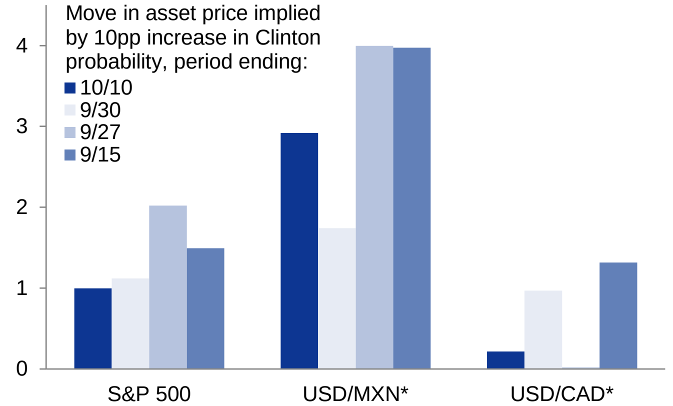
While many aspects of this election are unusual, sector implications are somewhat more conventional. We would expect an easier regulatory climate for the more heavily regulated sectors, like energy, healthcare, and financial services under Trump, who has criticized several of the Obama Administration's regulatory initiatives. Clinton looks likely to follow a similar approach to the current administration. However, as noted above, if Democrats also win majorities in both chambers of Congress, tax and spending policies could be enacted over likely Republican opposition, with negative implications for biotech and pharma (Medicare discounts or rebates), financial services (taxes on bank leverage), and energy (reduction of tax incentives for oil/gas production). Other subsectors could benefit however, like health services and renewable energy, through an expansion of subsidies.

A Clinton presidency and divided government: the base-case, and maybe also the best-case, scenario for risk assets

Over the last several weeks, an increase in the probability of a Clinton victory in prediction markets has been associated with a rise in US equities and an appreciation of the Mexican peso and Canadian dollar. Our interpretation is that market participants are more focused on the potential negative effects on growth and corporate profits of Trump's trade proposals than they are on the potential positive effects of possibly more expansionary fiscal policy under that scenario. Greater policy uncertainty under Trump may also be a factor in markets' election pricing.

Markets seem positive on a Democrat in the oval office…

Move in asset price implied by a 10pp increase in Clinton probability, %



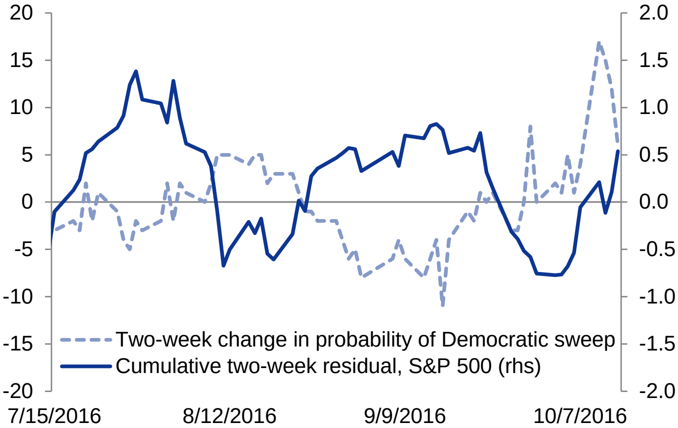
*Inverted; positive change implies appreciation against the US dollar.
Source: Bloomberg, Predictwise, Goldman Sachs Global Investment Research.

Too much of a good thing?

While markets seem to react positively to an increased probability that Clinton wins, we expect that there could be a negative reaction in risk assets if Democrats win control of Congress and the White House. Indeed, the S&P 500 has tended to react poorly to increases in the implied probability of a Democratic sweep, after removing the estimated effects of changes in growth, inflation, and policy expectations. The upshot is that the equity market appears to favor Clinton to Trump, but also seems to prefer divided government over single-party control.

…but not on Democrats controlling Congress, too

Two-week change in probability of a Democratic sweep, pp vs. cumulative two-week residual, S&P 500, pp (rhs)



Source: Bloomberg, www.PredictIt.org.

Alec Phillips, Senior US Economist

Email: alec.phillips@gs.com *Goldman, Sachs & Co.*
Tel: 202-637-3746

Where they stand on key issues

	Clinton	Trump
Personal Tax	• Impose 4% surtax on those with income >$5 mn • Impose 30% minimum effective tax rate for those with income >$1 mn (the "Buffett Rule") • Limit value of deductions/exclusions to 28% rate • Tax carried interest as ordinary income; tax derivative mark-to-market gains annually as ordinary income • Tax capital gains at ordinary income tax rates for assets held <2 years and at the current 20% rate for assets held at least 6 years, with a sliding-scale tax rate in between • Raise taxes on large estates • Increase child tax credit	• Reduce personal tax rates to 12% (for income <$75k), 25% ($75k-$225k), and 33% (>$225k) for joint filers; for single filers, rates apply to ½ the income levels in each bracket; low-income taxpayers would pay no income tax • Repeal the alternative minimum tax, estate tax (except on some capital gains), Medicare tax on investment income • Increase standard deduction; eliminate personal exemptions; limit value of itemized deductions; allow child/eldercare deductions and childcare rebates for some • Tax carried interest as ordinary income • Tax dividends and capital gains at 20%
Corporate Tax	• Impose "exit tax" on untaxed foreign earnings of companies pursuing tax inversions; raise ownership change threshold to 50% to qualify for inversion • Limit earnings stripping via interest deductions • Create additional R&D incentives • Offer tax relief for manufacturing/coal communities experiencing job and investment losses • Allow small businesses to deduct investment expenses	• Reduce corporate tax rate to 15% • Eliminate corporate alternative minimum tax • Repeal most corporate tax preferences • Tax unrepatriated foreign profits at a one-time 10% rate • Allow US manufacturers to choose between expensing capital investment or deducting interest costs • Raise cap for on-site childcare credit; allow deduction of employers' contribution to employee childcare costs
Trade	• Oppose TPP unless currency and auto provisions strengthened • Renegotiate NAFTA and review other trade agreements • Impose "duties, tariffs, or other measures" against countries manipulating currencies • Take countervailing action against dumping • Oppose China's "market economy" status, which affects the US' ability to take anti-dumping action	• Oppose TPP • Renegotiate NAFTA • Declare China a currency manipulator • Bring trade cases against China and implement tariffs on Chinese imports if Beijing does not halt "illegal activities, including its theft of American trade secrets"
Immigration	• Enact immigration reform legislation with a path to citizenship • End provisions barring illegal immigrants from re-entry for 3 or 10 years if they leave the US as part of the process to obtain a green card • Focus deportation efforts on threats to public safety • Continue and potentially expand deferred action programs introduced under Obama via executive order	• Allow immigration that is selective, "within historical norms" as a share of the population, and prioritizes domestic workers • Build a wall on the southern border; increase enforcement and deportation; terminate Obama's executive orders on deferred action programs • Require e-verify nationwide to confirm eligibility to work • Halt visa issuance to countries with inadequate screening
Infrastructure	• Boost spending by an extra $275bn over next five years, financed through business tax reform • Set up a National Infrastructure Bank • Reinstate Build America Bonds program, which offered subsidies or tax credits to incentivize investment	• Increase infrastructure spending by a substantial but unspecified amount; has suggested his plan would exceed Clinton's in size
Minimum Wage	• Raise federal minimum wage to $12/hour	• Position unclear: has expressed support for a $10/hr federal minimum wage, but this is not part of his official campaign documents

	Clinton	Trump
Social Security	• Oppose efforts to close the deficit via privatization, benefit cuts, tax increases, lower cost-of-living adjustments, or increases in the retirement age • Increase benefits available to widows or caretakers	• Keep promises made under current program • Use overall economic plan to support growth and maintain social security, with potential to consider "what changes might be necessary for future generations"
Healthcare	• Offer a "public option" under the Affordable Care Act • Increase ACA subsidies; lower out-of-pocket costs • Allow people 55 and older to buy into Medicare • Work to expand Medicaid in all states • Allow participation in ACA exchanges regardless of immigration status • Repeal the "Cadillac tax" on high-cost health plans • Negotiate Medicare Rx prices; expand drug rebates • Allow access to lower-cost, imported drugs • Penalize drug companies for "unjustified price increases" • Set research targets for pharmaceutical companies that receive federal support	• Repeal the Affordable Care Act • Promote individual Health Savings Accounts • Allow tax deduction for individual health insurance premiums • Allow health insurance to be purchased across state lines • Leave Medicaid administration to states • Allow access to lower-cost, imported drugs • Has argued for negotiating Medicare Rx prices, though this proposal is not in current campaign documents
Student Loans	• Offer free tuition at in-state, four-year public institutions for families with incomes <$125,000 • Offer free tuition at all community colleges • Create a $25 bn fund supporting educational institutions serving minorities • Lower interest rates on student loans; allow refinancing at current rates, with no repayment beyond 10% of income and debt forgiveness after 20 years	• Unspecified reforms targeting universities to reduce the cost of tuition and the student debt burden "in exchange for federal tax breaks and tax dollars"
Financial Regulation	• Impose an annual fee on liabilities of banks with >$50bn in assets, scaled according to their level of risk • Increase regulatory authority to reorganize/break up large financial institutions • Strengthen Volcker Rule provisions • Impose a tax on high-frequency trading • Impose new margin/collateral requirements on repos • Enhance regulatory reporting for hedge funds, PE firms • Strengthen Financial Stability Oversight Council • Increase individual and corporate accountability for white-collar crime, with greater resources for prosecution	• Reduce overall regulation and put any new regulations under temporary moratorium (this applies beyond the finance sector) • Has previously called for repealing or significantly revising Dodd-Frank, though current campaign documents do not mention this
Energy	• Support renewable energy production, including a significant increase in solar capacity, with $60bn in projects and competitions • Allow clean energy production on federal lands • Increase public investment in clean energy infrastructure and related R&D programs • Strengthen efficiency/pollution standards; cut methane emissions; reduce oil consumption • Cut tax benefits for oil and gas companies • Spend $30 bn to support and invest in coal communities	• Promote energy independence • Allow leasing of energy resources on federal lands • Lower drilling restrictions and increase shale exploitation • Allow new coal mining leases on federal lands (currently under moratorium); revisit other coal regulations • Revive Keystone Pipeline project • Eliminate Clean Power Plan, Climate Action Plan, Waters of the US rule • Abandon Paris Climate Change Agreement; cease US funding of UN climate change programs

Source for both pages: Campaign documents, AARP, Washington Post, Politico, Tax Policy Center, Committee for a Responsible Federal Budget; compiled by Goldman Sachs Global Investment Research.

Interview with Larry Sabato

Larry J. Sabato is the founder and director of the University of Virginia's Center for Politics. He is a *New York Times* best-selling author and a frequent political commentator on national and international TV. His election predictions, published under *Sabato's Crystal Ball,* have had a 98% accuracy rating in projecting all races for President, Senate, House, and Governor since 2000. Sabato has authored or edited two dozen books on US politics, and has held visiting appointments at Oxford and Cambridge universities. Below, he lays out his prediction for a Clinton win in November and explains why "hidden" Trump voters are unlikely to move the needle by much.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: You predict Clinton will win by a large margin at this point—341 electoral votes to 197. How confident are you in this prediction?

Larry Sabato: Very confident. We follow the polling averages, but we also incorporate information we receive from political contacts in the swing states as well as from the campaigns. Our first electoral college prediction issued at the end of March was almost precisely where it is right now, and never once since then have we predicted Clinton would receive fewer than the 270 electoral votes needed for a majority. The only period when she ran into some trouble was in mid-September, following her gaffe about Trump supporters and questions about her health. There is normally more variation in presidential odds, but this year they have been very consistent.

Allison Nathan: What would Trump have to do to win?

Larry Sabato: It would take some kind of external event that suggested incompetence or a lack of preparation on the part of the Obama administration. But frankly, even then, it's difficult to imagine a scenario that could get Trump elected. He would have to find some way to increase the white share of the electorate to 75% or 76%, compared to the 72% that it was in 2012 or the 70% that some have projected it will be this year. I break it down by race because Trump is winning the majority of the white vote while losing all minorities by record amounts. Never since Latinos became a force in American politics has there been a Republican candidate doing so poorly with them: Mitt Romney did terribly with Latinos in 2012, receiving 27% of their vote, but Trump is currently in the mid-teens. And with African Americans, Trump is down at around 3%, which is half of what Barry Goldwater got in 1964 after voting against the Civil Rights Act. All of this means Trump would have to do something that's never been done before, which is to increase just one slice of the electorate by a massive amount.

Besides that, Trump would have to get at least Mitt Romney's share of the white vote—close to 60%—and he isn't there yet. He is the first Republican candidate since we have gathered this data who is not carrying college-educated whites; he's breaking even with college-educated white men and losing with college-educated white women. So even among white voters it's difficult for Trump to rack up the votes he needs.

Allison Nathan: Given how critical turnout will be, which of the candidates do you think is doing a better job of ensuring their voters show up to the polls?

Larry Sabato: For a long while, Trump was doing a much better job of motivating his base. But the Democratic base is usually slow to rouse, and we are now seeing Democrats become more interested and excited—partly because of their support for Obama, whose approval rating is strong in the low 50s, but also because of their fear of Donald Trump. Trump's campaign mistakes have done what Clinton could not have achieved herself in energizing the Democratic base.

> "Trump would have to do something that's never been done before [in order to win the election], which is to increase just one slice of the electorate by a massive amount."

Allison Nathan: What do you make of the theory that some Trump supporters don't want to voice their political leanings, making the polls inaccurate?

Larry Sabato: I have been doing this since the 1960s, and the people who think that the polls are wrong are almost always supporters of the losing candidate. This is precisely what happened in 2012, when there was a big movement to "unskew" the polls because some observers insisted that they were biased in favor of the Democrats. But it turned out that the polls were actually skewed in favor of Romney, and Obama won by 5 million votes.

Now, Trump may be a special case. But I'm not convinced it will make a difference. You can think of his core support base—white voters—in two halves. The first half is non-college-educated voters who are openly enthusiastic about him. I've never met a blue-collar Trump supporter who was shy about it. And the second half is college-educated white voters, some of whom could indeed be hesitant to admit they support him. But I doubt those voters are worth more than a percentage point or two of the vote. Americans generally express themselves, and college-educated voters in particular are more inclined to make an argument for their candidate than to lie about their view. Besides, if there are hidden Trump voters, you would expect them to be more forthcoming in an anonymous online poll than in a live interview. But I've looked carefully at the data, and at most there is about a one percentage point difference between online polls and live phone polls. Even if you double that, it would not be sufficient to overcome Clinton's margin.

> "For the House, our current projection is that the Democrats will pick up about 12 seats of the net 30 they need for the majority… But if Hillary Clinton runs up her margin substantially, a Democratic House cannot be ruled out because even some senior, supposedly safe incumbents could lose in that scenario."

Allison Nathan: More generally, people seem doubtful about the accuracy of polls and prediction markets lately, and more worried about surprises. Should they be?

Larry Sabato: I've yet to find any evidence that they should be. The most common concern people cite is the failure of the polls to predict Brexit. There is just one giant problem with that comparison, other than the fact that the UK referendum was a vote on an issue rather than a candidate: The British electorate couldn't be more different from ours. It is 94% white, with only a 6% minority in the voting population. We have an electorate that is 70% white and 30% minority, with the latter overwhelmingly opposed to Trump.

That being said, I've been doing this for too long to rule out a surprise, so I always assign probabilities to outcomes. And right now I give Hillary Clinton a 75% chance of winning, and Donald Trump a 25% chance.

Allison Nathan: What will be most important to watch in heading into these last few weeks?

Larry Sabato: Most observers would say the third debate. But I'm skeptical it will matter, because at this point there are so few truly undecided voters. If the past is any indication, half of them won't vote, and those who do will split about the same way as the overall electorate—no more than 60-40 for a single candidate. To me, it's much more important at this stage to find out what is happening with early and absentee voting. When I started in politics, maybe around 5% voted absentee, and there was no early voting at all. This year, around 40% of votes will be early or absentee. So I'm watching to see who has the better organization for this share of the vote—and the reality is, it's not even close. The Democratic campaign is well-oiled, getting out there, and banking solid votes very early. I'll predict to you flatly that Trump will win the vote on Election Day—maybe not by much—but Clinton will win that 40% pretty substantially. So far, everywhere we can measure it—places like Florida, North Carolina, and Nevada, to mention just three—it is turning out very well for the Democrats.

Allison Nathan: How much impact could any one campaign development have at this point?

Larry Sabato: I find that embarrassing or exciting episodes create a bubble for the candidate, either positive or negative. For example, a good debate will create a positive bubble, but the air eventually leaks out of it. That is the reason why the last debate—this year, on October 19th—is held well in advance of Election Day, to give plenty of time for the air to go out of any bubbles. And the same could be said of campaign revelations. There is still enough time for the air to leak out of recent headlines, but we will have to see if anything new pops up on either side in the weeks ahead.

Allison Nathan: Where do you see the odds for the Senate and the House? How might the presidential election influence voting down the ballot?

Larry Sabato: For the House, our current projection is that the Democrats will pick up about 12 seats of the net 30 they need for the majority. But if Hillary Clinton runs up her margin substantially, a Democratic House cannot be ruled out because even some senior, supposedly safe incumbents could lose in that scenario. It's happened plenty of times before. So I think a Democrat-led House is unlikely, but not impossible.

As for the Senate, we're following it on a daily basis, particularly the six very close races that will determine control. We currently have 47 seats for the Democrats—including Wisconsin and Illinois flipping from the GOP—and 47 for the Republicans. The six seats that will determine control are in Nevada, Missouri, North Carolina, New Hampshire, Indiana, and Pennsylvania—two blue states, two purple states, and two red states. It could easily end up 51-49 or even 52-48; no matter what, you're not going to have a big margin. And if it's 50-50, which it might be, then the new vice president will break ties.

Allison Nathan: What kind of mark do you think this election season will leave on future races? What is the biggest lesson learned?

Larry Sabato: Last summer, you could not find anybody in the political system who thought Trump would even come close to the nomination—and I mean anybody. That's one reason he won it. Remember, his was a hostile takeover; he received only 38% of the vote during the competitive period of the Republican primaries, with the other 62% going to other, generally more established candidates. If the party leadership and the senior donors had taken Trump seriously early on and directed resources towards one or two strong candidates to oppose him, a more electable ticket could have come out of the primaries. The GOP would have had to make some tough choices, but they would have preferred those choices to having Donald Trump as their nominee. Instead, they ended up with one of the candidates, if not *the* candidate, that Hillary Clinton could beat. So lesson number one is: Take candidates like Trump seriously and spend resources to defeat them.

Lesson number two is that the Republicans must take account of changing demographics. I remember saying after 2012 that if the Republicans were focused on the electorate, they would not pick two white males again for their ticket. Guess what? They picked two white males again for their ticket. Even if Clinton wins a third presidential term for the Democrats, a fourth term is by no means assured, as George H.W. Bush proved. But for Republicans to have a fighting chance in 2020, they need to project an image that is more diverse and inclusive; putting a woman, Latino or African American on the ticket would go a long way toward achieving that.

Taking stock of equity implications

Ben Snider tells equity investors what to expect when they're electing

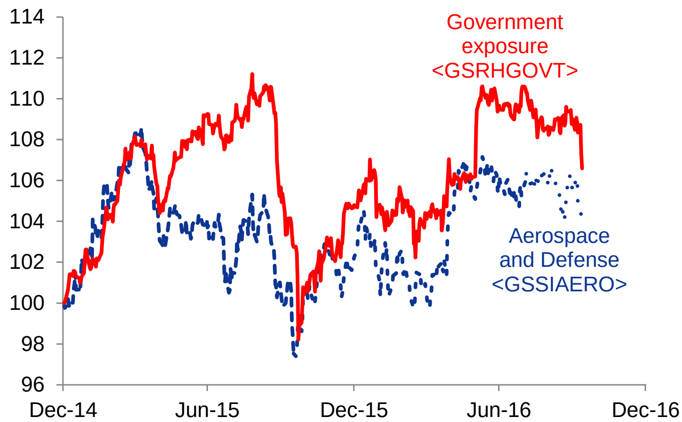
After months of discussing the election and its implications, in the last two weeks US equity investors have started voting with their wallets. A "kink" has formed around Election Day in the S&P 500 volatility term structure, and the tone of client conversations has shifted from theoretical to practical. Since the second debate, investors have increasingly focused on the possibility of a "wave election"—if Democrats were to capture the White House and make large gains in both chambers of Congress—but many others believe that polls and prediction markets understate true Republican odds. For investors, of course, the candidates' policy platforms have to be discounted by the likelihood of implementation—and even successful implementation will take time—so "headline risk" will be the more immediate equity mover than real policy changes. Nevertheless, several themes have emerged as key areas of focus for investors contemplating the post-election landscape.

United we stand: Areas to watch regardless of victor

Increased government spending on infrastructure and/or defense appears to be the most likely policy outcome of the election, regardless of victor. At the broadest level this would boost US GDP growth, which should help raise interest rates, lift corporate earnings, and benefit the equity performance of cyclical industries and factors. Among broad sectors, industrials stand to benefit the most from increased fiscal spending. In addition to defense stocks, the sector contains construction and engineering companies that would likely be among the beneficiaries of increased infrastructure investment. We recommend investors focus on a basket of companies with the highest government revenue exposure (GSRHGOVT), which has outperformed the S&P 500 by more than 200 bp this year but still carries a 10% P/E discount to the market.

Go for government exposure

Indexed relative performance of GS baskets vs. S&P 500



Source: Goldman Sachs Global Investment Research.

Corporate tax reform is another issue that both Hillary Clinton and Donald Trump would like to address. The median S&P 500 company pays an effective tax rate of 29%, 10pp below the statutory corporate rate. Changes to the corporate tax code would affect the earnings outlook for most firms, particularly if the changes were tied to a tax holiday encouraging the repatriation of overseas cash. Our basket of stocks with the largest amount of earnings reinvested overseas (GSTHSEAS) holds $1.7 trillion of permanently reinvested foreign earnings and is most likely to benefit from a repatriation tax holiday. Investors who expect a change in policy regarding the taxation of *future* earnings should buy a basket of companies with the highest effective tax rates (GSTHHTAX) relative to firms with the lowest rates (GSTHLTAX), which are most at risk.

Other investment themes to watch include trade (where both candidates' protectionist rhetoric could benefit US stocks with high domestic sales—GSTHAINT), and wages and income inequality (as proposals by both candidates to raise the federal minimum wage would affect firms with large exposure to minimum wage employees and customers).

Divided we fall: Key sectors where proposals differ

Clinton and Trump differ on policies that would affect stocks in the healthcare, energy, and financial services sectors. In healthcare, Clinton's policies would likely weigh on the performance of biotech and pharma stocks given her calls to lower prescription drug prices. Trump's stated desire to repeal the Affordable Care Act poses a risk to the healthcare providers and services industry (see pg. 14).

In energy, Clinton's proposed initiatives would support renewable energy stocks while Trump's plans appear more favorable for fossil fuels. In the event of a Clinton victory, the potential negative impact of her positions on fossil fuels may also affect industrials firms with exposure to energy capex.

For financial services, as in healthcare and energy, Trump opposes new regulations, while Clinton has proposed strengthening the Volcker Rule and levying a "risk fee" on large banks. However, in most scenarios we do not expect financial regulation to be as significant of an issue during the next couple years as it has been during the last several.

Reading the markets for clues

Regressing the performance of equity industries vs. changes in the presidential odds suggested by the Iowa Electronic Market, we find that market behavior has mirrored the candidates' policy platforms. As Democrat odds have increased, healthcare providers, which have benefitted from the Affordable Care Act, and firms in the textiles, apparel & luxury goods industry, which could see costs rise if tariffs are placed on imports, have outperformed. Professional services firms and software companies, many of which have large stockpiles of offshore cash, have shown a strong correlation with Republican odds.

History bodes well for post-election upside

Whatever the outcome on November 8, the resolution of uncertainty should be positive for US equities. In 21 presidential election seasons since 1932, the S&P 500 has posted inconsistent performance in the first month immediately after Election Day, rising in roughly half (11/21) the episodes. Once the market has time to digest the election results, however, it typically rises; in the six months post-election, the S&P 500 has risen nearly two-thirds of the time by a median of +3%.

Ben Snider, Senior US Equity Strategist

Email: ben.snider@gs.com *Goldman, Sachs & Co.*
Tel: 212-357-1744

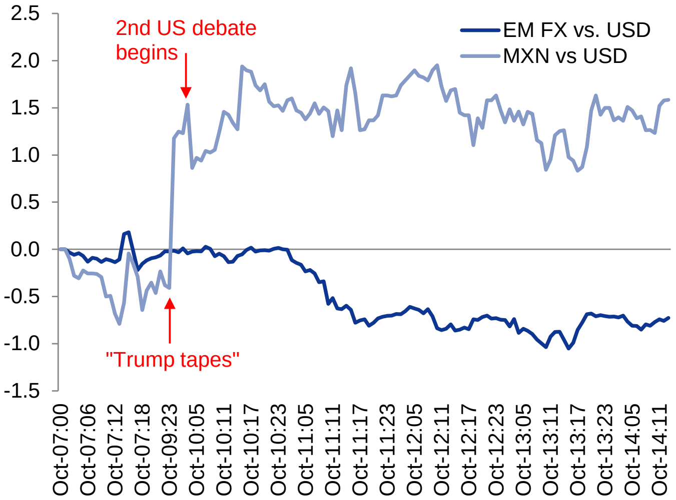
US polling and the Mexican peso

Mark Ozerov measures the US election risk premium priced into the MXN, finding that a Clinton win could mean a 4-5% rally from here

Given Donald Trump's statements about imposing tariffs on imports from Mexico and renegotiating the North American Free Trade Agreement (NAFTA), many investors have made the MXN their instrument of choice to express views on the US election outcome. The intraday path of the currency around some of the pivotal points of the presidential race suggests that MXN has been very responsive to US election news. At the same time, MXN has been the worst-performing major EM currency year-to-date and one of the few to depreciate meaningfully against the US dollar. The key questions are therefore how much US election risk premium is priced into the MXN and whether it is likely to reverse its underperformance.

US politics pushing the peso around

Cumulative % appreciation vs. USD in the displayed currency



Dates are month-day-hour format in GMT. EM FX vs. USD is the simple average of cumulative % changes vs. the USD in each of the following: COP, RUB, KRW, MYR, PHP, SGD, THB, INR, IDR, BRL, CLP, PEN, ILS, TRY and ZAR.
Source: Thomson Reuters, Goldman Sachs Global Investment Research.

Separating out local, global, and "Trump" factors

Deciphering how much "US election premium" is priced into the MXN is tricky, since part of the currency's under-performance likely reflects a worsening of global macro factors. One example is the slowdown in the US economy, which has been a headwind for Mexico's industrial sector. To arrive at a "cleaner" measure of the MXN, we therefore strip out the influence of such global macro factors, estimating how the currency would have moved if it had traded in line with its historical relationships with several key variables—US, Chinese, and European growth, US inflation, global financial conditions, and oil prices. We then compare the gap between this "adjusted MXN" and the actual MXN with the odds of a Trump presidency implied by prediction markets.

Indeed, there appears to be a relationship between the two, with the MXN underperforming its macro drivers as Trump secured the Republican nomination through spring and early summer, and then again as Hillary Clinton's post-convention lead narrowed in September. Statistically, the relationship suggests that a 1pp increase in the probability of Trump's victory maps to roughly 0.3pp of MXN underperformance.

Of course, the gap between the actual and the adjusted MXN could reflect local factors—modest deterioration in Mexico's twin deficits, for example, as well as domestic political dissatisfaction in the run-up to the 2018 election against the backdrop of only moderate growth. Yet, considering the timing of the swings and their relationship with the projected odds of a Trump win, we believe that it at least a major portion of it reflects the US election risk premium.

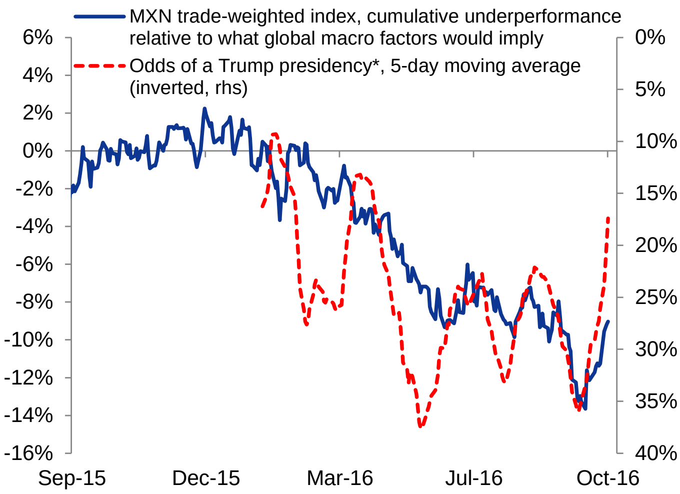
$/MXN needs more than a Clinton win to reach fair value of 16

So, where does this leave us in terms of the path going forward? Taking the mapping at face value, a potential Clinton win would imply a roughly 4-5% MXN rally from current levels, holding other things equal. This would bring the $/MXN closer to our 12-month forecast of 18. However, MXN appreciation beyond that—towards our long-term fair-value estimate of 16—would require macro factors to move in a more supportive direction, chief among them an improvement in the external balance and re-acceleration in US growth from its slow H1 pace.

In the event of a Trump win, the picture is less certain. Simply extrapolating the probability of him winning from around 15% currently to 100% would imply roughly 25% additional MXN depreciation. That said, the extent of the actual depreciation could be different depending on how the market reacts to a higher probability of a Trump win, let alone an actual victory. Alternatively, MXN deprecation could be reduced if (i) Trump were to shift his rhetoric away from renegotiating trade agreements as his odds of winning improved, or (ii) if the Mexican central bank were to step up with further rate hikes and/or FX intervention to dampen pressure on the currency.

Tracking Trump

MXN TWI performance relative to global factor model vs. odds of Trump victory* (inverted, rhs)



**Odds of Trump nomination (which ultimately converge to 1) multiplied by odds of Republican candidate winning. Source: Iowa Electronic Markets, Goldman Sachs Global Investment Research.*

Mark Ozerov, EM Macro Strategist

Email: mark.ozerov@gs.com
Tel: +44-20-7774-1137
Goldman Sachs International

Interview with Jonathan Rauch

Jonathan Rauch is a Senior Fellow for Governance Studies at the Brookings Institution. He is the author of six books and many articles on public policy, culture, and government. He is a contributing editor of *National Journal* and *The Atlantic* and a recipient of the 2005 National Magazine Award. His 1994 book, *Demosclerosis*—revised and republished in 2000 as *Government's End: Why Washington Stopped Working*—argues that the US government is becoming gradually less flexible and effective with time. Below, he contends that reforms to US political processes have stripped politicians and lawmakers of the tools they need to govern, creating chaos in Washington.

The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.

Allison Nathan: You have described the dysfunction in Washington, DC, today as "chaos syndrome". What do you mean by that?

Jonathan Rauch: Chaos syndrome is a chronic deterioration in the system's capacity to organize itself in order to solve problems and get things done, both in government and in politics. We see evidence of this everywhere today. It has been 20 years since regular appropriations bills were all passed; what used to be routine business like passing farm bills and surface transportation bills takes years instead of weeks or months, if it gets done at all. And raising the debt limit has been dicier and dicier every time we have to do it.

Allison Nathan: How did we get here?

Jonathan Rauch: The key to understanding how we got here is understanding where we came from. US politicians are independently elected, which means they are accountable to the public—at least occasionally—but not to each other. It is therefore a huge challenge to motivate politicians to work together, which is essential in the team sport of politics. So from the start of the Republic in the late 18th century, informal organizing institutions and networks emerged, including political parties, party machines and careerists, and committee and seniority systems within Congress. These "intermediaries" essentially established an informal favor economy that made politicians accountable to each other; in short, "If I help you, you help me." Their methods could sometimes be considered unsavory, but they worked: they brought order from chaos. The intermediation that these institutions and networks enabled was crucial to getting things done in Washington.

So what happened to this system? It did not commit suicide or die of old age. We reformed it to death. We made a series of deliberate choices over the last 40 or 50 years that have systematically weakened organizing institutions and politics.

Allison Nathan: What reforms to the political process have been particular impediments to the ability to organize?

Jonathan Rauch: Reforms to the nominating process that replaced insider-led caucuses with direct primaries greatly reduced the influence of professional politicians and political insiders over who runs for office and who gets elected. This has made it very difficult for party leaders to protect team players and incumbents from insurgents. Indeed, the Tea Party's great discovery was that, despite their small numbers, they could stop people from compromising on Capitol Hill by threatening them with a primary challenge in their home district. Legislators constantly worry about becoming the next Eric Cantor, the Republican House Majority Leader who shockingly lost to an unknown Tea Partier in his 2014 primary.

In addition, reforms since the 1970s have tightened the rules on big political donations. This has made it much harder for parties and leaders to move money to reward cooperative behavior. It has also had the perverse effect of pushing money to independent groups, which tend to be more extreme and are not accountable to anyone. These groups thrive on protest, and they aren't subject to the same constraints as parties are.

Allison Nathan: What about reforms to Congress?

Jonathan Rauch: Starting in the 1970s, but especially in the 1990s, the seniority and committee systems in Congress came under attack. These systems had rewarded people who had proven their loyalty and ability to work as a team player, and they also helped ensure that the people at the top were experienced. Without them, we've found that Congress is little more than a collection of entrepreneurs and pressure groups. In the House, for example, the balance of power has shifted toward a small but cohesive minority of conservative Freedom Caucus members who don't hesitate to oppose their own leaders and maximize their individual gain.

We also largely eliminated pork-barrel spending and earmarks, which took away a useful and usually inexpensive tool to incentivize members of Congress to vote for bills that were unpopular back home. And finally, we introduced transparency rules that opened up what were traditionally closed-door negotiations. This made it much harder to negotiate candidly.

Each of these practices might look unseemly in isolation, but remove them, and you find that nothing is getting done at all. We have effectively stripped politicians of the incentives and tools that they need to organize their world.

Allison Nathan: Many observers attribute today's dysfunction to the establishment itself—arguing that politicians have lost touch with the electorate, leading voters to support outsider candidates instead.

Jonathan Rauch: I don't think there is really much evidence that the establishment has lost touch. Representatives in the House are elected every two years, so they have to be in touch with someone! That being said, it is clear that people are unhappy with government. That has been the case since the Watergate era and it seems to be getting worse. But being unhappy with the *direction* of government is a different problem than the inability to organize. We can argue about whether to go to the left or to the right, and someone will always be unhappy no matter what the decision. But you want to be able to go *somewhere*. If you systematically weaken the establishment to the point at which they're not capable of organizing their way out of a paper bag, it's not that some people will be unhappy, but that you've lost the capacity to address problems. So I would actually say that the country abandoned the establishment, not the other way around.

Allison Nathan: What about increased polarization and social media? How significant is their role?

Jonathan Rauch: Of course, being a lawmaker has become harder because the country has become more divided. Polarization, media fragmentation, and many other factors contribute to the dysfunction. But chaos syndrome is like chronic fatigue syndrome; it exacerbates all other problems. In today's divided environment, where small veto groups are able to disrupt the whole system, it is all the more important that people are able to organize, build coalitions, and seize opportunities for constructive compromise. Chaos syndrome prevents them from doing that.

Allison Nathan: Aren't there benefits to disrupting the political status quo?

Jonathan Rauch: The problem is not disruption itself. In fact, political insurgencies or protest candidates tend to bring new energy and ideas, and provide a voice for people who are angry with the system. The problem is that chaos syndrome wreaks havoc on the system's ability to continue governing through disruptions. By weakening insiders and professional politicians—people who actually have a long-term stake in keeping the government functioning because they make their living off of it—we have made it harder and harder to absorb disruption. Protest is great, but it can't be the dominant force in the system if we expect to get anything done.

Allison Nathan: What can be done to fix the dysfunction?

Jonathan Rauch: There are no magic bullets. We just need to slowly and steadily move in the direction of rebuilding—rather than tearing down—the processes that we need to organize politics, which is very doable. Even with existing tools, Senate Majority Leader Mitch McConnell has begun to rebuild political machines; he has protected every single incumbent Republican senator from challenges by the Tea Party and others in this election cycle and in the prior one. By doing so, he has given these senators some comfort that they can work cooperatively without fear of retribution. This is an optimistic sign, but we could be doing more to restore the strength of intermediaries, whether it's bringing back the earmarks that help grease the wheels of lawmaking or lifting limits on party donations.

Allison Nathan: Weren't the reforms you described intended to combat unfairness, corruption, etc.? Might undoing them cause more harm than good?

Jonathan Rauch: I'm not advocating for taking us back to the 19th century glory days of parties and middlemen. But we are a long way from needing to worry about too much corruption in the US, and I am actually much more concerned about excessive anti-corruption in the US today. That is not true for other parts of the world where corruption is running rampant. But in the US, we have redefined corruption so expansively that it includes much of what politicians actually need to do—like pork-barrel spending—to get things done.

Allison Nathan: How do you convince voters to put more trust in the establishment and allow a return to some of the old ways of getting things done?

Jonathan Rauch: I write articles about it! And the response to my recent article about this in *The Atlantic* was much bigger than to anything I have ever published in my 35-year career in journalism. I am hearing from a lot of young people that this message resonates. I think that there is a "silent minority" that understands instinctively that politics is about give and take. It is about people making deals and influencing each other and creating networks of supporters. These people understand that our grandparents, who did a pretty good job of organizing their political world, were not all crooks and fools.

I would make two more points. The first is that ideas take a long time to take hold. I am a veteran of the gay marriage debate, which took almost twenty years to win. That was much more of a long shot when we started than convincing people that you need a stronger political establishment. The second point is that these kinds of changes do not need to involve grassroots movements. The reforms of the past 40+ years were almost all driven from the top down by a small circle of reformers, non-profits, some politicians, and committees. The public was never really in on it. The same could be true of the reforms that need to be implemented today. If we can begin to restore organization, and if Congress and politics begin to function better as a result, my guess is that people will approve of these changes and a virtuous rather than a vicious cycle will take hold. I think this will happen because it needs to happen.

Allison Nathan: Is there reason to expect more deterioration or improvement of the dysfunction under either presidential candidate?

Jonathan Rauch: No in terms of their platforms, but yes in terms of their approaches. Clinton is doing it the old-fashioned way; she has raised tens of millions of dollars for the Democratic Party and other candidates, and is worrying about her ability to bring in Democratic votes in down-ballot races. That is how politicians create their coalitions of support, so that when they are elected they can actually govern; a lot of people will owe Clinton something, and she will owe a lot to others. As a Democrat who has been in the ranks for 30 years, she has successfully pitched herself as someone who understands the party and cares about it.

Donald Trump is the very opposite model. He brags about owing nothing to anybody. He has no connections in politics. Republican candidates down the ballot are running away from him. If elected, he almost certainly could not govern, because he will say, "Do this!" and Capitol Hill will say, "Why?" So this election is not just about two candidates, but about two very different models of politics and governance.

Healthcare: big proposals, small chances

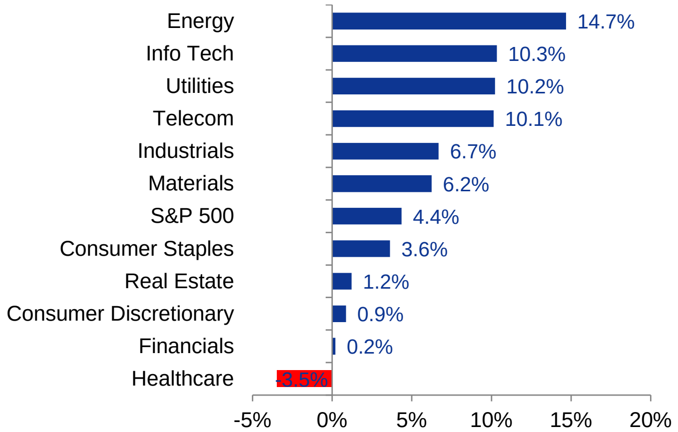
Asad Haider writes that the strong odds of a divided government make major healthcare reforms unlikely but that pressure on drug pricing and transparency could persist

Heading into the election, healthcare reform is a central policy agenda item that is top of mind for investors. Recent media and political outrage over drug pricing has brought a new urgency to the issue. So has the growing financial stress of ACA exchanges; large scale exits from these exchanges by public-company-run plans, along with insolvencies at some Consumer Operated and Oriented Plans (CO-OPs) following an enrollment bias toward higher-cost members, have resulted in significantly fewer ACA plan offerings for 2017, and those that remain are offering more costly and less generous benefits.

Considerable differences in the presidential candidates' proposals to address these problems have heightened investors' focus on the election. Hillary Clinton's proposals include expanding the ACA, bringing down out-of-pocket costs like copays and deductibles, and penalizing drug companies for "unjustified" price increases. While details of Donald Trump's healthcare plan are less clear, he has vowed to "completely repeal Obamacare" and allow for full competition in the health insurance market across state lines, and has noted that "though the pharmaceutical industry is in the private sector, drug companies provide a public service." This policy uncertainty, coupled with concerns about drug pricing and ACA sustainability, has weighed on healthcare stocks, pushing healthcare to the bottom slot among S&P 500 sectors year-to-date after five years of outperformance.

Election uncertainty proving troublesome for healthcare

YTD performance of S&P 500 sectors



Source: FactSet.

Don't hold your breath for big changes in the base-case… but watch the key risk, a Democratic sweep

Despite increased market focus on the potential for a Democratic sweep of the White House and both chambers of Congress, our US economists continue to believe that divided government—a Clinton presidency, Democrat-majority Senate, and Republican-majority House, remains the most likely election outcome (see pgs. 4-5 for more). Therefore, despite the candidates' proposals, the potential for major healthcare-related legislative action is low. In particular, abolishing the ACA would be very unlikely to receive sufficient support in a divided Congress. One exception may be legislative action in response to the challenges facing the ACA exchanges, which are leading to rapidly rising costs for consumers and may necessitate some form of intervention next year. Specifically, support for a "public option"—government-run insurance that would compete with private insurance companies—has been rising.

There are also other areas of healthcare policy with substantial bi-partisan support where legislative action seems somewhat likely. These include (i) funding for the National Institute of Health on research projects, which would be positive for the Life Sciences Tools industry, and (ii) allocating more funds to the FDA generics division, which would be a double-edged sword for the healthcare sector, given that it could speed up generic drug approvals but also bring more price competition.

Political pressure on drug pricing is also becoming less partisan as consumers (voters) are feeling the pinch from higher out-of-pocket costs from high-deductible plans, which have grown disproportionately vs. other insurance plans. But other constraints are likely to inhibit significant change on this issue, at least in the near term. For example, the impact of regulatory mechanisms created under ACA to control ballooning drug costs is likely to remain limited, and pilot programs to lower Medicare Part B drug and treatment costs have been met with significant industry-wide resistance.

However, in the event of a Democratic sweep, there could potentially be more pressure on securing greater discounts and/or higher rebates for Medicare drugs, which would have negative implications for biotech/pharma. This is an important risk that we've noted may not be priced into the healthcare sector as a whole, although some subsectors like healthcare providers could benefit from an expansion of ACA.

Expect more pricing scrutiny, no matter who gets elected

Regardless of who gets elected, the onus to "prove worth" and provide greater transparency on opaque industry pricing models will likely continue, not just for biopharmaceutical companies, but across the entire healthcare ecosystem, including pharmacy benefit managers, drug retailers and distributors. As such, investors should be prepared for an increase in political discussion, congressional hearings and heightened media attention that could moderate the magnitude of future price increases from the drug industry.

Recent examples suggest this has already begun. The focus on Epipen pricing led to an unprecedented response from Mylan to voluntarily lower the price and issue an authorized generic version of its own drug. And Allergan's CEO has now pledged a "social contract" with patients to limit price increases. It may not be surprising to see other biopharma companies follow suit and start self-regulating by both limiting price increases, and by showing restraint in setting initial prices to pre-empt potential US government controls.

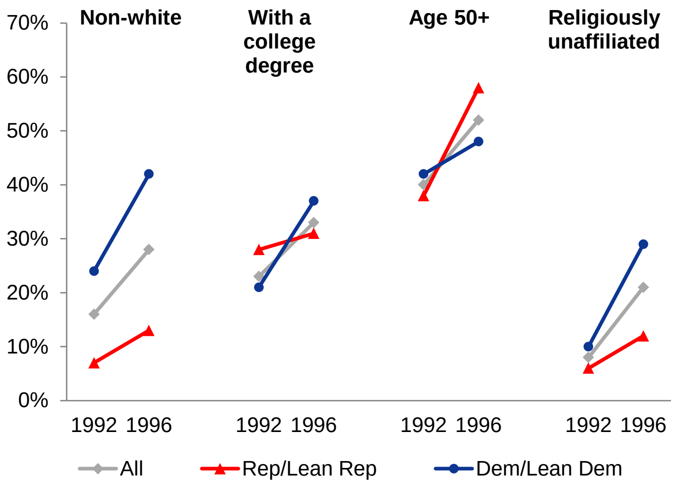
Asad Haider, Healthcare Sector Specialist

Email: asad.haider@gs.com *Goldman, Sachs & Co.*
Tel: 212-902-0691

The 2016 US presidential election in pics

An evolving electorate

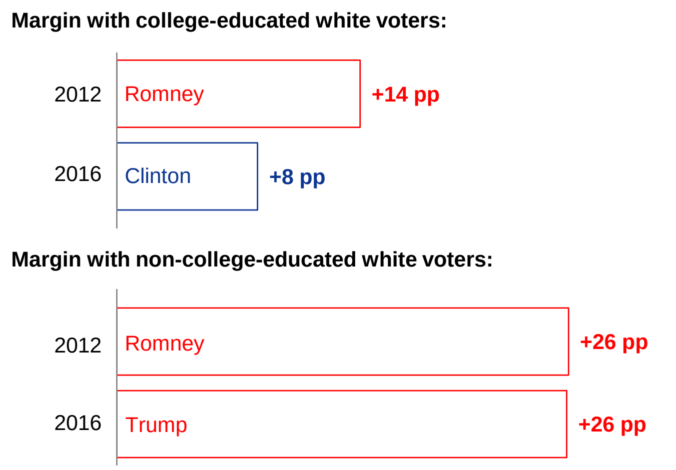
Share of survey respondents falling in each category, 1992 vs. 2016



Annual totals. 2016 surveys conducted Jan-Aug. Source: Pew Research Center.

White college grads go blue

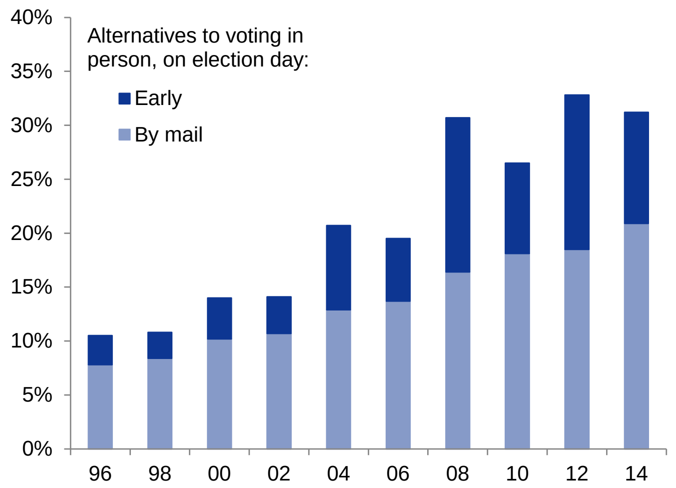
Dem./Rep. margin with white voters, 2012 election vs. 2016 polls



2016 data as of Oct. 17. Source: CNN exit polls, Bloomberg Politics Poll Decoder.

Why wait for November 8?

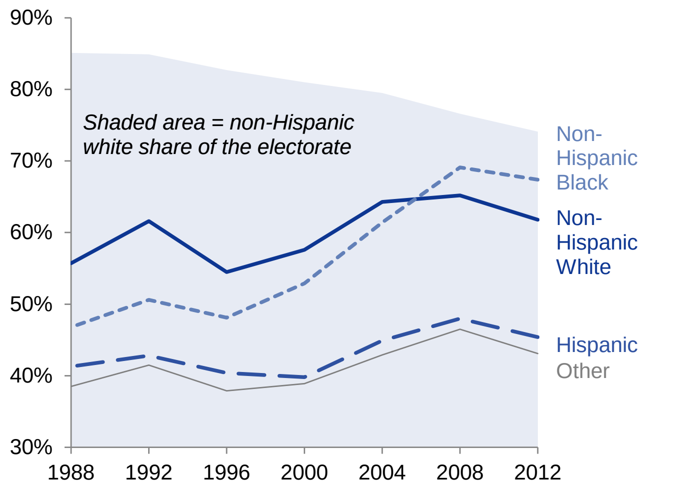
Share of early/mail-in voting over time



Source: US Census Bureau, Current Population Survey, Nov. 1996-2014.

Turnout trends

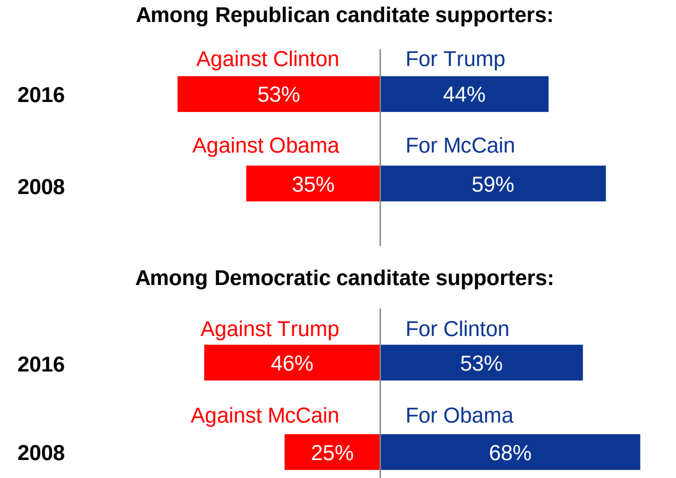
Voter turnout by demographic group; white share of the electorate



Source: www.electproject.org, Census Bureau Current Population Survey.

The lesser of two evils?

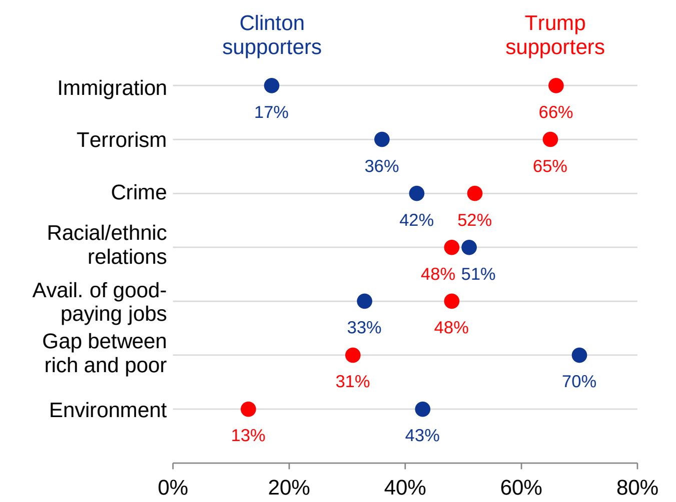
Share of survey respondents who said their choice was more a vote *for* one candidate or a vote *against* the other candidate



Based on registered voters. 2016 survey conducted Aug. 9-16.
Source: Pew Research Center.

Polarized priorities

Share of voters saying each issue is a "very big problem" in the US



Based on registered voters. Survey conducted Aug. 9-16.
Source: Pew Research Center.

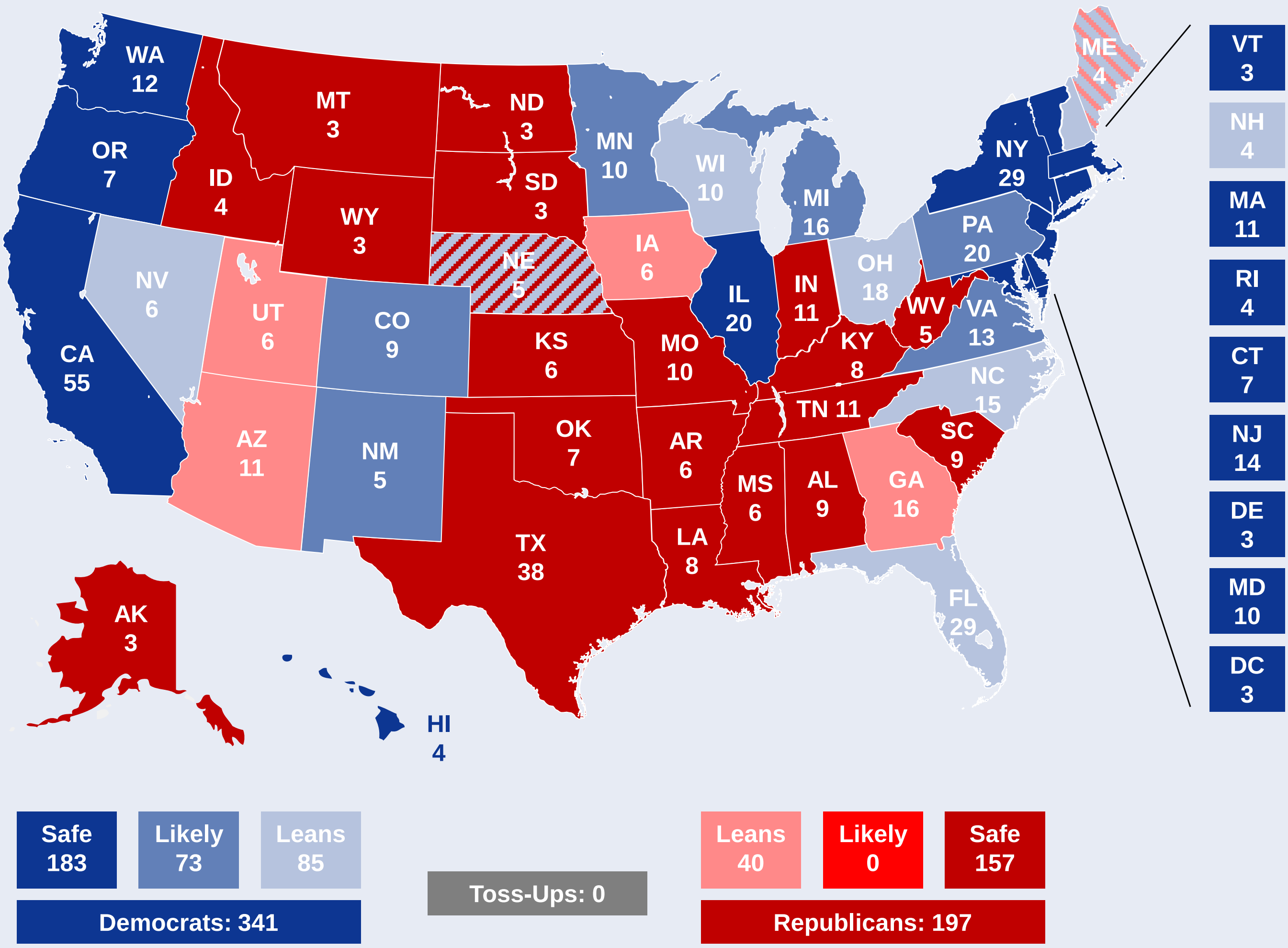
US elections, explained

- The US presidential election is held every four years on the Tuesday after the first Monday in November. Voters do not, technically, participate in a direct election of the president. They choose "electors", who are pledged to one or another candidate. This "Electoral College" was established as a compromise between congressional and popular vote. The Electoral College consists of 538 electors. A majority of 270 electoral votes is required to elect the president.
- Each state has a certain number of electors to the college, based on the size of its population. Specifically, each state's entitled allotment of electors equals the number of members in its Congressional delegation: one for each member in the House of Representatives plus one for each of its two Senators.
- In almost every state, the winner of the popular vote gets all the Electoral College votes in that state. Because of this system, a candidate can take the White House without winning the popular vote. The exceptions to this are Maine and Nebraska, where the state winner receives two Electors and the winner of each congressional district receives one Elector. The District of Columbia is allocated 3 electors and treated like a state for purposes of the Electoral College.
- On the first Monday after the second Wednesday in December after the presidential election, the electors meet in their respective states, where they cast their votes for President and Vice President on separate ballots. Each state's electoral votes are counted in a joint session of Congress on the 6th of January in the year following the meeting of the electors. The Vice President, as President of the Senate, presides over the count and announces the results of the vote. The President-Elect takes the oath of office and is sworn in as President of the United States on January 20th in the year following the Presidential election.
- If no Presidential candidate wins 270 or more electoral votes, the House of Representatives decides the Presidential election. The House would elect the President by majority vote, choosing from the three candidates who received the greatest number of electoral votes. The vote would be taken by state, with each state having one vote. It would be up to the group of representatives from each state to decide among themselves how their state would cast its one and only vote. Smaller states like Wyoming, Montana and Vermont, with only one representative would wield as much power as California or New York. The House would have until the 4th of March to select a president.

Source: National Archives and Records Administration (NARA), US Federal Register.

The votes

US electoral votes and presidential leanings projected by Prof. Larry Sabato's *Crystal Ball* as of October 17



Source: Sabato's Crystal Ball (www.centerforpolitics.org/crystalball).

Summary of our key forecasts

	GDP Growth (% yoy)				FX				Equity				Rates (% eop)				Revision Notes
	2016		2017		3-mth		12-mth		3-mth		12-mth		Policy*		10-yr		
	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	2016	2017	2016	2017	
Global	3.1	2.9	3.5	3.2	-	-	-	-	-	-	-	-	-	-	-	-	
					EUR/$		**EUR/$**		**SP500**		**SP500**						
US	1.5	1.5	2.1	2.1	1.08	1.10	1.00	1.09	2100	2163	2175	2286	0.50 to 0.75	1.25 to 1.50	2.00	2.50	
					EUR/$		**EUR/$**		**Eurostoxx 50**		**Eurostoxx 50**						
EURO AREA	1.5	1.5	1.3	1.3	1.08	1.10	1.00	1.09	2900	3012	3200	3172	0.00	0.00	-	-	
					EUR/$		**EUR/$**		**DAX 30**		**DAX 30**						
GERMANY	1.7	1.8	1.1	1.3	1.08	1.10	1.00	1.09	-	10439	-	10831	-	-	0.30	0.70	
					$/JPY		**$/JPY**		**TOPIX**		**TOPIX**						
JAPAN	0.6	0.6	1.0	0.8	108	103	115	105	1300	-	1400	-	-0.10	-0.10	0.05	0.20	
					$/CNY[+]		**$/CNY[+]**		**MXCN**		**MXCN**						
CHINA	6.7	6.6	6.4	6.3	6.70	6.75	7.00	6.86	-	-	70	-	2.25	2.00	-	-	On October 6, we raised our 2016 GDP growth forecast to 6.7% from 6.6%, reflecting a relatively mild slowdown in growth from Q2 to Q3.
					$/BRL		**$/BRL**		**BOVESPA**		**BOVESPA**						
BRAZIL	-3.2	-3.3	1.1	1.0	3.20	3.30	3.50	3.43	-	59037	-	64511	13.50	11.00	-	-	
Commodities	Brent crude oil ($/bbl)				Copper ($/mt)				Gold ($/toz)				Corn ($/bu)				
	3-mth		12-mth		3-mth		12-mth		3-mth		12-mth		3-mth		12-mth		
	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	GS	Cons	
	43	50	57	57	4500	-	4000	-	1300	-	1250	-	375	-	375	-	

Note: Recent revisions marked in red; GDP consensus is Bloomberg; all other consensus is Reuters; commodity 12-mo consensus is Reuters for 2017 average.

[+] CNY daily fix * Euro area rate is MRO rate. China rate is 7-day repo rate.

Source: Bloomberg, Thomson Reuters, Goldman Sachs Global Investment Research.

Glossary of GS proprietary indices

Current Activity Indicator (CAI)

Measures the growth signal in the major high-frequency activity indicators for the economy. Gross Domestic Product (GDP) is a useful but imperfect guide to current activity. In most countries, GDP is only available quarterly, is released with a substantial delay, and initial estimates are often heavily revised. GDP also ignores important measures of real activity, such as employment and the purchasing managers' indexes (PMIs). All of these problems reduce the effectiveness of GDP for investment and policy decisions. Our CAIs are alternative summary measures of economic activity that attempt to overcome some of these drawbacks. We currently calculate CAIs for the following countries: USA, Euro area, UK, Norway, Sweden, China, Japan, Hong Kong, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, Thailand, Australia and New Zealand.

Financial Conditions Index (FCI)

Financial conditions are important because shifts in monetary policy do not tell the whole story. Our FCIs attempt to measure the direct and indirect effects of monetary policy on economic activity. We feel they provide a better gauge of the overall financial climate because they include variables that directly affect spending on domestically produced goods and services. The index is calculated as a weighted average of several financial variables, including short-term interest rates, long-term interest rates, equity prices, and the trade-weighted dollar.

Global Leading Indicator (GLI)

Our GLIs provide a more timely reading on the state of the global industrial cycle than the existing alternatives, and in a way that is largely independent of market variables. Global cyclical swings are important to a huge range of asset classes; as a result, we have come to rely on this consistent leading measure of the global cycle. Over the past few years, our GLI has provided early signals on turning points in the global cycle on a number of occasions and has helped confirm or deny the direction in which markets were heading. Our GLI currently includes the following components: Consumer Confidence aggregate, Japan IP inventory/sales ratio, Korea exports, S&P GS Industrial Metals Index, US Initial jobless claims, Belgian and Netherlands manufacturing surveys, Global PMI, GS Australian and Canadian dollar trade weighted index aggregate, Global new orders less inventories, Baltic Dry Index.

Goldman Sachs Analyst Index (GSAI)

Our US GSAI is based on a monthly survey of Goldman Sachs equity analysts to obtain their assessments of business conditions in the industries they follow. The results provide timely "bottom-up" information about US economic activity to supplement and cross-check our analysis of "top-down" data. Based on their responses, we create a diffusion index for economic activity comparable to the ISM's indexes for activity in the manufacturing and nonmanufacturing sectors.

Macro-data Assessment Platform (MAP)

Our MAP scores facilitate rapid interpretation of new data releases. In essence, MAP combines into one simple measure the importance of a specific data release (i.e., its historical correlation with GDP) and the degree of surprise relative to the consensus forecast. We put a sign on the degree of surprise, so that an underperformance will be characterized with a negative number and an outperformance with a positive number. We rank each of these two components on a scale from 0 to 5, and the MAP score will be the product of the two, i.e., from -25 to +25. The idea is that when data are released, the assessment we make will include a MAP score of, for example, +20 (5;+4)—which would indicate that the data has a very high correlation to GDP (the '5') and that it came out well above consensus expectations (the '+4')—for a total MAP value of '+20.' We currently employ MAP for US, EMEA and Asia data releases.

Real-Time Inflation and Activity Framework (RETINA)

RETINA provides a comprehensive econometric methodology able to filter incoming information from the most up-to-date high frequency variables in order to track real GDP growth in the Euro area. Along with a GDP tracker, RETINA also captures the interrelated mechanisms of the area-wide pricing chain, providing a short-term view on inflation dynamics.

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Source of photos: www.istockphoto.com, www.shutterstock.com, NOAA-NASA GOES Project.

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