WHY FIVE OF SIX POSSIBLE ELECTION OUTCOMES COULD BE BAD FOR STOCKS

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Who will win Tuesday night, how will the market react Wednesday and what, if anything, should investors do about it? Before offering a suggestion, let me review why five of six possible election outcomes would likely cause stocks to sell off between now and the end of the year.

Although I believe the race remains too close to call, betting odds through late last week still suggested the more probable outcome was that Hillary Clinton would win and that the House would stay in Republican hands. This is, I believe, the only scenario in which stocks rally between now and the end of the year. Put another way, a President-elect Clinton could provide some post-election relief coupled with expectations that not much will change in a gridlocked Washington. That "all-clear" signal would encourage both U.S. and foreign investors to put money back to work and allow the focus to return to the Fed, the economy and corporate fundamentals.

But there are five other possible election outcomes that I believe would likely send stocks even lower over the next seven weeks.

1. *Hillary Clinton wins and the Democrats win the House and the Senate.* This is a low-probability event, but if it happened, the potential for higher taxes, more regulation and a complete government takeover of the health care industry become much more likely.
2. *Donald Trump wins.* The market began to discount this last week, but an actual Trump victory is not fully priced in. Foreign investors will likely view a Trump victory as an unsettling global event, one that could potentially undermine global trade and U.S. leadership in the world. Actual or threatened tariffs could have implications for U.S. multinationals and for the stocks of companies throughout emerging and developed markets that sell into the U.S.
3. *Donald Trump wins and the Democrats win the House or the Senate.* I believe this would be an even worse outcome for the U.S. market because it could dramatically reduce the chance for any meaningful tax reform in the next two years—one potential upside of a Trump presidency. The nation would be subjected to the uncertainty of Donald Trump running America's foreign policy, with near certainty that Congress would not pass his sweeping tax cuts or reforms to reignite economic growth at home.
4. *We get a contested election.* If the race is close and one of the candidates contests the results, there may be no definitive victor come Wednesday morning. If that happens, you get an extension of the partisan drama (and the accompanying cable TV coverage) through the fall, which means continued uncertainty and likely lower stock prices. The last time that happened, during the Bush vs. Gore tribulations of 2000, the S&P 500 Index sold off nearly 8% from election night through the end of the year. But unlike 2000, only eight justices today sit on the Supreme Court. So if the election needs to be adjudicated, the possibility of a deadlocked Supreme Court adds one more piece to an uncertain puzzle.
5. *Neither Donald Trump nor Hillary Clinton emerges* with 270 electoral votes on Tuesday night. There are many computations that generate a 269 to 269 tie in electoral votes. If neither Clinton nor Trump secures an Electoral College majority, the Constitution dictates that the next House of Representatives (sworn in on January 3, 2017) must choose the next president from the top three presidential candidates with the most electoral votes. Each state's congressional delegation gets one vote. That means, in all likelihood, House Republicans would control this process and choose Trump over Clinton. Put another way, as a practical matter, if the Republicans hold the House, the magic number for Donald Trump is 269 electoral votes, not 270. But before the House meets in January, members of the Electoral College must first meet on December 19th to cast their electoral votes. It's not an official tie until this final check and balance built into the Constitution by the founders actually happens. For example, if one elector from a state that Trump won overrules the will of the people and casts a vote for Clinton, the decision would never get to the House. Only about half the states

have laws compelling electors to vote for the party candidate chosen by the people in that state. States that have no such laws include Utah and Texas- states that Trump lost in the Republican primaries and whose party establishments have ties to prominent Republicans that have failed to endorse Trump (Mitt Romney in Utah and former presidents George W. Bush and George H.W. Bush in Texas). This last scenario takes us through the looking glass and down a rabbit hole, but it is not an impossible scenario because a remnant of the "Never Trump" contingent within the Republican Party may choose to play its lone, remaining trump card if provided the opportunity. All it would take is one party elder to shift one vote to deny Trump the White House and swing the election to Clinton.

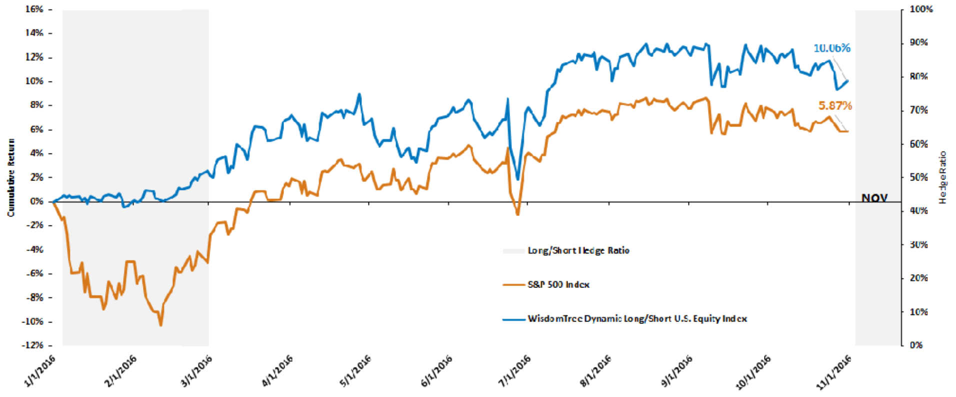
You got all that?

Hedging the Equity Market

So how can investors "hedge" some of the potential downside in the next few weeks? One way is to incorporate a long/short strategy into one's equity allocation.

WisdomTree created an exchange-traded fund (ETF) late last year that is designed to do this. It tracks the WisdomTree Dynamic Long/Short U.S. Equity Index, which modifies its equity exposure between 100% long, 50% long, and 0% net long, depending on the overall market environment. For the first time since early this year, the market environment has turned bearish, and thus the ETF that tracks the WisdomTree Index, the WisdomTree Dynamic Long/Short U.S. Equity Fund (DYLS), is now effectively market neutral. Below, we show how that hedging signal has helped the WisdomTree Dynamic Long/Short U.S. Equity Index outperform the S&P 500 by more than 400 basis points (bps) year-to-date. (The gray bar below denotes the periods when the Index's "hedging indicator" directed the Index to assume a 0% net long position).

WisdomTree Dynamic Long/Short U.S. Equity Index and the S&P 500 Index Year-to-Date Cumulative Total Return (12/31/15–10/31/16)



Source: WisdomTree, Bloomberg, as of 10/31/16. Past performance is not indicative of future results.

Click here to view the standardized performance for DYLS.

The hedging indicator within the WisdomTree methodology incorporates two fundamental drivers of quality and value to derive a "market signal." The value portion of this indicator did not change since September and still posts a "mixed reading." However, the quality or growth indicator derived from trends in operation margins (operating income divided by sales), net margins (net income dividend by sales) and ratios of operating cash flow to operating income moved from positive in September to negative for the month of November. The deterioration in fundamentals was great enough to generate a 0% net equity exposure signal.

Conclusion

For investors looking to dampen volatility and the impact of a potential market correction, consider DYLS. The short component of its underlying long/short Index, which is evaluated monthly, has been activated for the month of November.

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S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.

Basis point : 1/100th of 1 percent.

Hedging Indicator : An indicator in the strategy to show when and how much to hedge the long position.

Long (or Long Position) : The buying of a security such as a stock, commodity or currency, with the expectation that the asset will rise in value, the opposite of Short (or Short Position).