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Market Flash

The midterm results are in, but what do they mean for markets?

Assessing the impact of the US midterm elections on four key areas

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Key takeaways

- The results of the US midterms have had an initially supportive effect on US markets.
- Beyond this initial market response, we think there are important implications to explore for global markets, for various US equity sectors and for major macro themes.
- In this commentary, we examine four key areas: US politics, fiscal/monetary policy, domestic policy and foreign economic policy.

Going into yesterday's midterm elections, our base case scenario was that Democrats would take the House while Republicans would retain the Senate. That has come to fruition, and has had an initially supportive effect on markets, with US stocks and bonds supported and the dollar weaker. This US market response has in effect eased global financial conditions, supporting other currencies and financial markets in general, including emerging markets.

Beyond this initial market response, we think there are important implications to explore for global markets, for various US equity sectors and for major macro themes – including US Federal Reserve policy, global trade tensions and the relationship between the executive branch and Congress, which could affect economic policy and performance. Below, we focus on the market impact on four key areas: US politics, fiscal/monetary policy, domestic policy and foreign economic policy.

1. The political assessment

The United States will shift from unified Republican control to a divided government in the second half of President Donald Trump's current term. We expect greater difficulty, if not gridlock, for many aspects of the president's agenda as a result, but we do not see the midterms as hobbling Trump as a lame duck by any means. While Democratic control of the House implies greater political and legal difficulties, the result was short of a "blue wave" that would reject the president wholeheartedly, as the Republicans gained ground in the Senate.

- Democratic control of the House means that a number of investigations into Trump, his campaign and his businesses are likely to be launched. Importantly, the House Judiciary Committee will now fall under a Democratic chairperson, and will have unlimited subpoena power in any area it chooses to investigate (unlike Robert Mueller's investigations into Russian interference in the 2016 general election under the Justice Department). We believe Democrats are likely to challenge and try to distract the president over his past and current business dealings, tax returns and the Constitution's Emoluments Clause, which prohibits US officials from personally benefiting from office. That said, though the House may have enough votes to impeach, the Senate is very unlikely to convict, so we would expect a scenario similar to that of President Bill Clinton's in 1998. In other words, any concerns that Trump will not remain in office seem unfounded.
- The US Senate remains solidly Republican – more so than before the midterms. The Senate has been referred to as the "personnel department" of the US government, as it is responsible for confirming all high-level appointments by the executive branch. It will be able to continue confirming Trump nominees – and the process going forward will likely be less of a nail biter than the recent confirmation of Supreme Court Justice Brett Kavanaugh, for example. Because the Republican majority is bigger, we expect presidential nominees should be more easily confirmed and efforts toward deregulation should continue. At a minimum, a reversal of deregulation is unlikely, in our view. We believe these factors should support business optimism and support growth.
- Divided government in the wake of unprecedentedly high turnout for a midterm election suggests that the US electorate itself remains polarized. High turnout was expected to significantly boost the Democratic Party, but it appears to have also benefited Republicans in the Senate and in many congressional and gubernatorial races. This factor also suggests that Trump is far from a lame duck, and we expect him to continue to pursue his platform vigorously.

2. Fed policy and US budget policy implications

- We see the midterms as largely keeping the Fed on its gradual rate hike/balance sheet reduction path, rather than going further or faster in raising rates, which would have been a greater risk with a Republican sweep, since the chances of another round of fiscal stimulus would have been higher.
- We expect divided government to reduce the chances of another "unfunded" tax cut. The president had mooted/tweeted the idea of a middle-class tax cut in advance of the midterms — probably because of concerns that reforming both personal and income taxes were seen as benefit for the rich (but not middle-class voters) and as an increased tax burden on professionals and the well-off, mainly in urban and suburban areas and coastal states (who did indeed vote Democratic, according to election results thus far). Accordingly, a middle-class tax cut might require offsetting cuts in spending or tax increases to get through Congress. A Democrat-controlled House is likely to try to prevent the president from enacting policies that might help boost his chances for re-election in the 2020 general election.
- This combination of budget and Fed policy suggests the US economy may continue to grow, but may well decelerate in 2019-20 as the benefits of fiscal stimulus moderate in the face of rising rates. But in our view, it also lowers the chances of a boom/bust scenario further down the line (by reducing the risk of another fiscal stimulus that could boost inflation, which is already at the Fed's target, by lowering unemployment further and requiring the Fed to move faster).

3. Other domestic economic policies could be important for stocks

- There is a real possibility that the Trump administration may reach across the aisle and strike a deal with House Democrats for a significant infrastructure spending package, with fewer deficit hawks among Senate Republicans to oppose it. If so, we believe it would likely be targeted to specific regions and projects, and would support materials stocks. However, the upside for overall gross domestic product growth, inflation and Fed policy is probably limited, because state and local governments are the main sources of infrastructure spending, and "shovel-ready" projects at the federal level are limited.
- Conversely, both the president and Democrats seem to agree on greater regulation, and taxation, of technology companies, so further underperformance in the tech sector, which has been richly valued relative to other sectors, is a distinct possibility, in our view.
- The president and Democrats also agree on regulation of drug pricing, but we would expect any sell-off or underperformance in pharma and biotech stocks to be temporary. At the end of the day, we believe Senate Republicans are very unlikely to agree to any bill that would regulate drug pricing.
- In our view, Democratic control of the House almost guarantees that there will be no repeal of the Affordable Care Act (aka, Obamacare), which should ensure more clarity and stability in regulation and pricing for insurers and hospitals and the health care sector overall.
- Finally, both the president and Democrats have advocated an increase in the federal minimum wage. While we think it would be difficult to get through the Senate, if it were to pass, it would create pressure on US retailers and restaurants — but we would note that several states have already increased minimum wages, as have some major employers like Amazon. Therefore, the effects are more likely to be firm-specific than general.

4. Foreign economic policy is unlikely to change, at least not in the near term

- Divided government probably means that Trump will be more constrained in domestic policy in many areas than before, and is therefore likely to focus more, at least initially, on foreign policy — both trade and national security. The president has far more discretion over foreign policy in general, and trade and tariffs in particular, than in most areas of domestic policy (other than enforcement of regulation, which the Trump administration is likely to continue to soft-pedal as part of its effort improve the business environment). However, there is the distinct possibility that — especially if data shows tariffs' growing negative impact on the economy — the administration may take a more conciliatory approach to trade, especially as it begins to focus on its prospects for re-election in 2020.
- There is the potential for the Democratic House to work with the Senate, which is comprised of many "free trade" Republicans, to claw back some powers over tariffs if the administration continues to pursue its aggressive approach to trade policy. The US Constitution grants the power to levy tariffs to the Congress, and so it is not out of the realm of possibilities for Congress to attempt to claw back some of those tariff powers from the executive branch, especially if more signs appear that tariffs are hurting the US economy. But it is very unlikely that Congress will be able to achieve a veto-proof majority; however just the dramatic act of attempting to claw back powers may cause the administration to soften its stance on trade.
- The US-Mexico-Canada Agreement (USMCA), the newly revised North American Free Trade Agreement, will face approval in the new Congress and is likely to face tough scrutiny, but we expect it to pass because many state economies are highly integrated with both Canada and Mexico, and a failure would affect major constituencies on both sides of the aisle.

Conclusion

The Trump administration's agenda in the first year was very pro-growth — with deregulation, tax reform and fiscal stimulus as signature policies. But the second year has seen an emphasis on policies that can run counter to economic growth — primarily protectionism and a hawkish foreign policy in such areas as Iran sanctions. Global markets have reacted accordingly, with US stocks posting far more lackluster returns in 2018 than 2017. However, given the new composition of Congress, there is the potential for some stimulative policies to come to fruition and for the administration to further the pro-growth elements of its agenda through a more trouble-free political appointment process, and so we see the potential for some upside with US stocks.