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Divided Government: Taking Stock of the Midterm Election

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The results of the midterms are in and the scenario that was widely expected has played out. America has a divided Congress, with Republicans maintaining control of the Senate and Democrats regaining control of the House (Exhibit 1). While we are still parsing the details, the elections appeared devoid of any big surprises and has currently removed a large source of political uncertainty. Political "gridlock" may be back but it's a landscape that is hardly unfamiliar to investors. With the midterm elections in the books, investors can turn their attention back to what really matters over the long run: market fundamentals, which we believe remain solid.

Exhibit 1: New House and Senate Breakdown.

House of Representatives

Democrats	Republicans	Seats Gained
220	196	+26 for Democrats*

Senate

Democrats	Republicans	Seats Gained
46	51	+2 for Republicans**

*19 races left to be called.
**2 races left to be called.
Source: Bloomberg. Preliminary Data as of November 7, 2018 at 2:24 P.M.

To reiterate, the U.S. economy is in the midst of one of the longest economic expansions in U.S. history. While Washington matters, the private sector matters more and is the engine behind a $20 trillion economic behemoth having expanded at a 3.5% annual average clip. Unemployment levels are currently at multi-decade lows; and inflation remains moderate due to rising productivity gains. Consumer spending is currently growing at 3.5%+, supported by +200K jobs created on average over the last six months and wages picking up at a 3% rate. The U.S. manufacturing base has never been stronger. Corporate cash levels appear to be strong and copious. Foreign demand for U.S. securities remains robust. The U.S. continues to be not only a global tech titan but a superpower in aerospace, agriculture, education, finance, space, biotechnology, chemicals, and a host of other sectors. Against this backdrop, it is little wonder why the U.S. economy and U.S. equities have been the global leaders of the post-crisis era.

Peering into 2019, we expect U.S. economic and earnings growth to moderate, but not decelerate sharply. Valuation multiples should remain stable at levels consistent with higher interest rates, with solid earnings growth (around 6%-7%) being the primary driver of equity returns in 2019, in our view. We continue to favor equities over fixed income and emphasize diversification across asset classes in order to help weather higher levels of volatility as the cycle matures.

Below we highlight five key topics that will help shape the capital markets over the medium term.

HOW DO EQUITIES TEND TO PERFORM UNDER POLITICAL GRIDLOCK CONDITIONS?

While political gridlock is rarely conducive to policy making and leads almost inevitably to a rising volume of political noise, this far from ideal result may not adversely affect equity prices. Consider the following political historical statistics related to midterm elections:

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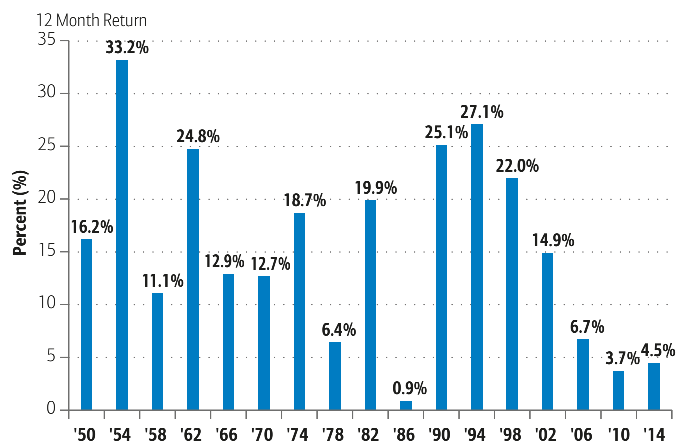
First, political noise seems to have been a factor contributing to the higher volatility we have seen so far in 2018, which is par for the course in midterm election years, during which stocks have experienced an average correction of 19%.[1] However, equities historically tend to bounce back from that correction on average by 31% over the next year.[1] A possible explanation for this dynamic could be that during midterm election years more populist policies are pursued (which often may not be market-friendly), and after the elections more growth-friendly policies are prioritized by presidents and politicians with an eye on their re-election prospects.

In addition, the third year of a presidential cycle historically tends to be the strongest, producing average returns of 16%. Since 1946, the S&P 500 has never fallen in the 12 months following a midterm election, instead experiencing an average gain of 15% during that period (Exhibit 2).[1] Finally, while every cycle is different, historically under a Republican president and a divided Congress, the S&P 500 has produced an average annual total return of 12%, suggesting that equities can still perform well under political gridlock.[2]

Exhibit 2: Equities Tend to Rally Following Mid-Terms.



Source: Strategas Research Partners. Data as of 2018. **Past performance is no guarantee of future results.**

WHAT POTENTIAL POLICY CHANGES ARE LIKELY TO OCCUR?

While the volume of political rhetoric will be dialed up over the next two years, we do not expect any significant policy change from Washington between now and the 2020 presidential election. With a divided government, additional tax cuts are unlikely and fiscal spending is expected to be constrained. A modest infrastructure bill is likely, as both Democrats and Republicans support greater infrastructure spending; however, a major legislative initiative could face hurdles, especially from political disagreements on funding and spending priorities. Also, the Democrats may not be all that motivated to reach an agreement with the White House prior to the 2020 presidential elections.

On the regulatory front, we expect the current regulatory framework to change little. Most regulatory changes from the Administration have not required congressional approval. We expect a great deal of political bluster for tighter regulation in energy, financials and healthcare, but don't expect any significant policy changes. Lower drug prices, however, is a bi-partisan goal, and could have an impact on certain healthcare stocks.

In our opinion, the debt ceiling needs to be raised in 2019, which undoubtedly will bring to the fore much political grandstanding and threats of a government shutdown. Debt-limit debates are also usually the most decisive and bitter with a divided Congress. 2019 will hardly be no different, although in the end, we believe the debt limit will be raised.

Interestingly, more women are headed for Congress. At least 92 women won in the House and 10 had won in the Senate (joining 10 already in the upper chamber), for a total of 112 women—the most women to serve in Congress at once in history, the previous record being 107. Whether or not this cohort becomes an effective voting bloc within Congress remains to be seen but it could emerge as a significant political and market force for change by sector/industry.

WHAT GEOPOLITICAL DISRUPTIONS OR OUTCOMES SHOULD INVESTORS EXPECT?

We believe the Democrats will become more involved in U.S. foreign policy, although investors should expect more of the same, or the status quo. We expect a tougher congressional tone towards Russia, Saudi Arabia and North Korea, but little if any of this noise will be market-moving.

China could prove the exception. U.S.-Sino relations remain on the boil, and support for tougher measures against China, via trade and investment restrictions, is bipartisan, in many cases.

On trade, the U.S.-Mexico-Canada Agreement will be up for a vote in early 2019, and is expected to garner Democratic support given that the updated version includes provisions that raise wages in Mexico and boosts manufacturing in the U.S., and has broad support among labor groups, generally aligning with Democratic interests.

[1] Strategas Research Partners as of November 2018.
[2] BofAML Global Research as of October 18, 2018.

In many key areas, like immigration and energy security, the White House can work unilaterally, without congressional approval.

WHAT DO THE ELECTION RESULTS MEAN FOR INTEREST RATES AND THE U.S. DOLLAR?

Rarely are midterm elections market-moving for either interest rates or the U.S. dollar—and it was no different this time. The greenback fell slightly in overseas trading immediately following the election results, while 10-year Treasury yields shed a few basis points. Nothing dramatic.

Our base case is that interest rates, supported by solid growth and moderately upward inflation pressures, are set to grind higher over the near-term. The broad election result—"political gridlock"—essentially obviates the need for the Federal Reserve (Fed) to reassess its growth and inflationary assumptions, meaning the Fed trajectory for rates remains unchanged. We expect the Fed to raise the Fed Funds rate again in December, and raise rates another three times over the balance of 2019. Presidential jawboning of the Fed is not likely to end any time soon, but it should have little effect on Chairman Powell and the Federal Reserve.

The future path of the U.S. dollar remains dependent on U.S. interest rates relative to the rest of the world's foreign demand for securities, and other market-related factors. As our base case, we expect the dollar to remain stable over the near-term as the U.S. maintains its growth leadership and interest rates continue to grind higher.

WHO ARE THE WINNERS AND LOSERS AMONG SECTORS?

The political effects on various sectors will take time to play out but we believe that certain areas of bipartisan consensus could have notable implications at the sector-level. Winners could include the industrials and materials sectors, with the need for a modest infrastructure bill producing at least some consensus between the two parties, and leading to increased spending on badly needed upgrades to the nation's roads, highways and bridges. Progress on the trade front ahead of the 2020 election would also be a tailwind for consumer, materials and industrials companies, especially those that have recently cited concerns over rising input costs and margin pressure as a result of tariffs.

Losers could include certain communication services firms, which may feel the pressure of increased demands for regulation and oversight, given some bipartisan support for and concern about consumer privacy. And finally, the impact on the healthcare sector should be neutral overall. A split Congress will likely reduce the potential for a single-payer healthcare system from Democrats as well as a potential repeal of the Affordable Care Act from Republicans. However, concern over drug prices by both parties could negatively impact industries within healthcare, such as biotech companies.

SUMMARY

A split Congress is now in effect beginning in 2019. This scenario has been well-discounted across the capital markets and the prospects for equities have traditionally been favorable in the 12 months that follow such midterm elections. Within this backdrop, however, we expect various areas of interest between the two parties to come into focus in the new year and up ahead of the 2020 presidential election. In our view, the "core" areas that are likely to set the tone for investors in the next year include: the debt ceiling decision; a "bridge" trade agreement with China; the Fed's pace of hikes; immigration; infrastructure and healthcare.

All of these except the Fed's monetary policy are likely to be used in a variety of negotiations as both parties try to solidify their base heading into the 2020 election. A major positive surprise regarding a trade agreement with China is not yet discounted in the market, in our opinion. Removing this uncertainty prior to next year could be a catalyst that propels U.S. equities back to record highs. At the end of the day, headline risk is high in the coming year but we do not expect material changes to policy that would undermine economic fundamentals. Therefore, we remain constructive on equities, corporate earnings, the U.S. economy as a whole, and continue to expect a grind higher in interest rates in the next year.

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