THIS MONTH'S TOPIC

US Midterm Election: Potential Economic Agenda and Market Implications

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The essential

In the upcoming US Midterm elections on November 6, there are high expectations of divided Congress, with the Democratic Party taking control of the House of Representatives and the Grand Old Party (GOP) retaining control of the Senate. Other scenarios are possible: the Republicans could maintain control of Congress, or the Democrats could sweep both the House and the Senate. In this piece, we examine some of the reasons the most likely election outcome is a divided Congress. We then look at the economic agendas for both parties, and potential issues around their implementation. Finally, we analyse possible investment implications on US equities and fixed income markets.

Uphill Battle for GOP

Political fundamentals point to a favourable backdrop for the Democrats to regain control of the House. Currently, Republicans control both chambers of Congress – the House majority is 237-193, with 5 vacancies; the Senate majority is a narrow 51-49. The Democrats need to gain 23 seats in the House and 2 seats in the Senate to take control.

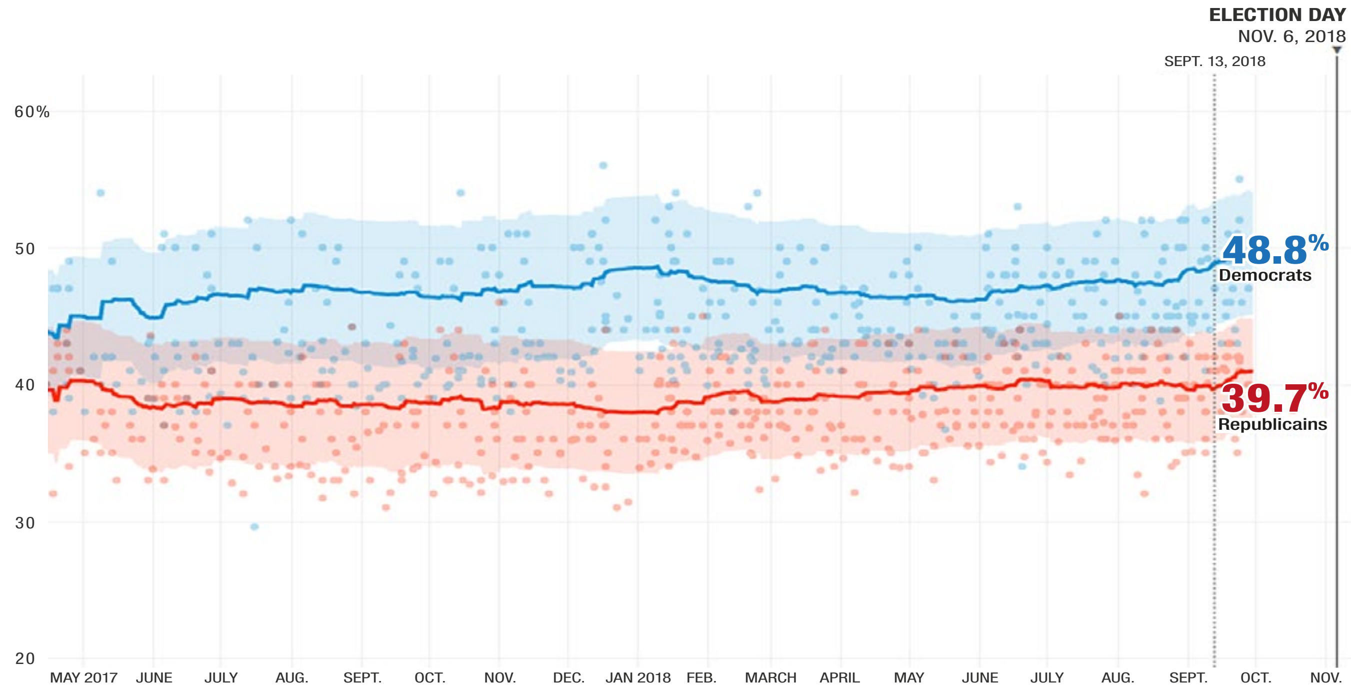
The House has more potential to flip to the Democrats than the Senate because there are many more marginal Republican seats compared to marginal Democratic seats. There are 23 districts that voted for the GOP House candidate and Secretary Hillary Clinton in 2016, compared with 7 districts that voted for the Democratic House candidate and Trump. On the other hand, the Democrats are clearly on the defensive in the Senate with the need to defend 26 seats out of 35 seats that are up for reelection. In addition, Red State Democrats will be trying to win reelection in states where Trump's margin of victory was at, or exceeded, 20% (Missouri, Indiana, Montana, North Dakota and West Virginia).

Why Democrats are favoured to win the House

Generic Ballot

The Democrats are holding a solid lead in the generic ballot. The generic ballot is based on polls that ask voters which party they would support in a congressional election, Democratic or Republican. Some political strategists believe that due to gerrymandering (politically designed districts by the party in charge); the Democrats need around a 7% lead in the generic ballot to gain a majority in the House. The current generic ballot has an 8.5% Democratic lead over the GOP (Chart 1).

Chart 1: Democrats hold a solid lead in the Generic ballot

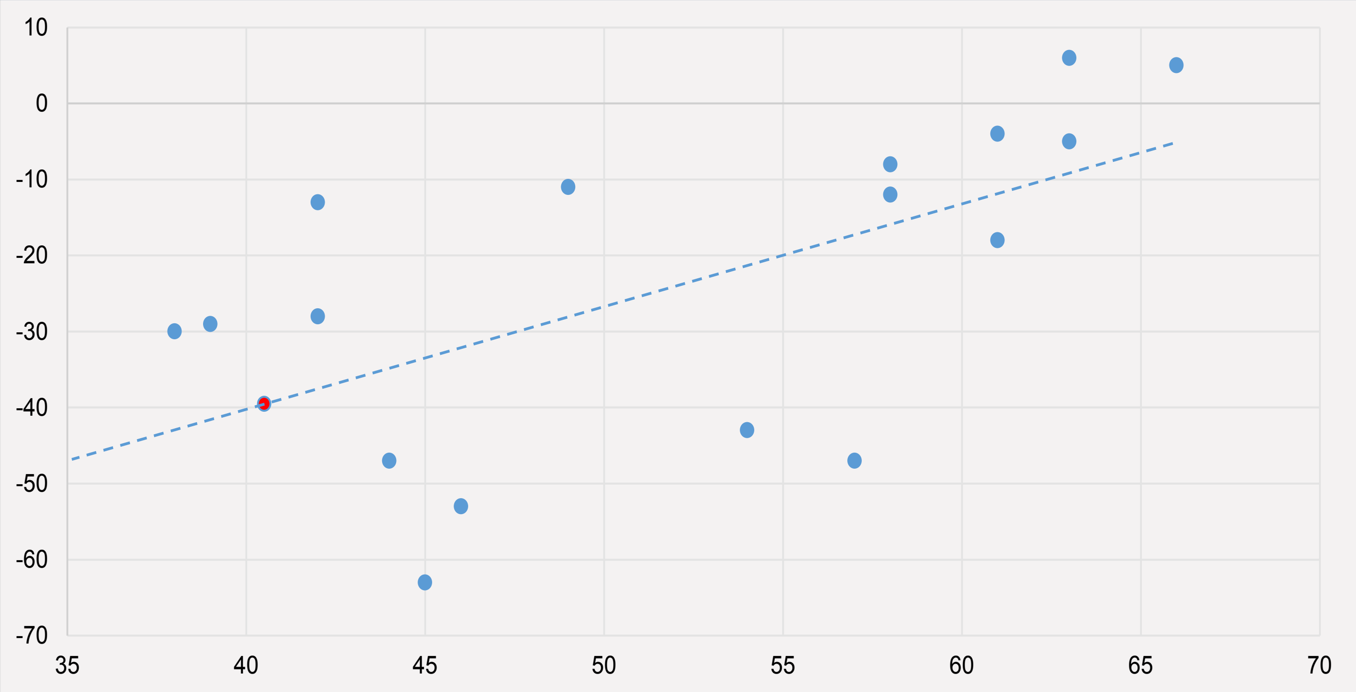


Source: FiveThirtyEight, as of 9/13/18

Trump's Approval Rating

Historically, when a President's approval rating drops below 50%, the ruling party generally loses 25 or more seats in the House. According to our recent average of polls, Trump's approval rating has fallen to 40.5% as of 9/9/18. Based on our correlation of a president's approval rating and seat changes to the House, Trump's current approval rating suggests a potential loss of about 40 seats (Chart 2).

Chart 2: Seat gain/loss in House of Representatives vs. approuval Rating



Source: Amundi Pioneer, as of 9/10/18

Fundraising

Finally, another key indicator of strength is fundraising. Democratic candidates have outraised their Republican counterparties in 71 out of 101 districts. Significantly, Republican incumbents are trailing in two-thirds of those districts.

Policy Implications: Re-emergence of Gridlock

The two parties are running on disparate economic policy platforms. The Democratic Party unveiled "A Better Deal", which is an economic plan aimed at increasing government spending, raising the minimum wage, and expanding healthcare. The Republican Party will focus on decreasing expenditures, introducing more tax reform measures and eliminating the Affordable Care Act (ACA).

Democratic Economic Agenda

- Increase government spending. Democrats want to spend $1 trillion on a long-term infrastructure plan to rebuild roads, bridges, transit, rail etc... In addition, they want to spend $100 billion on education and $70 billion on affordable public housing.
- Raise the minimum wage. While there are no specifics in "A Better Deal" platform, a Democratic bill introduced in the Senate last year proposed raising the Federal minimum wage from $7.25 to $15 by 2024, and indexed the minimum wage to median wage growth thereafter.
- Healthcare. Democrats plan to continue to defend the ACA and look to expand Medicaid, Medicare and Social Security. As part of "A Better Deal", Democrats look to lower prescription drug costs.
- Taxes. Democrats want to reverse corporate and upper income tax cuts
- Other. Paid family and sick leave. Child care/universal pre-K.

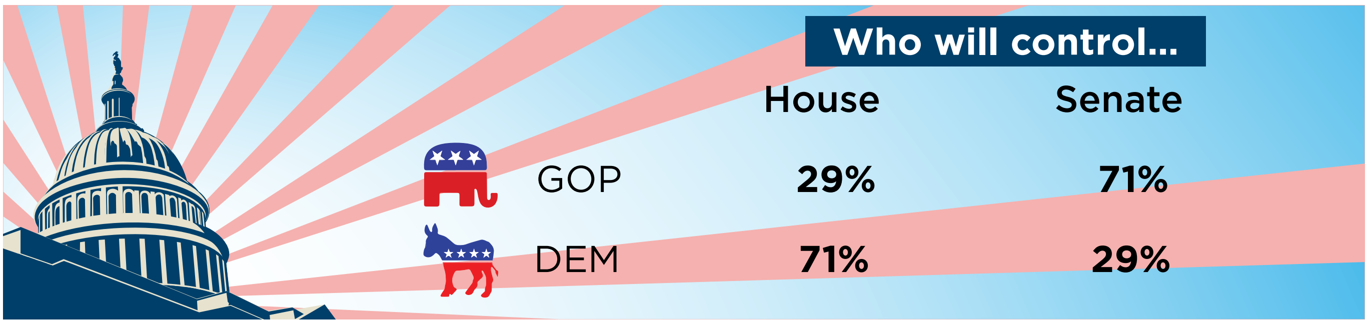
Republican Economic Agenda

- Tax Cuts and Jobs Act 2.0 (TCJA 2.0). The next phase of tax cuts include making the personal income tax cuts permanent and implementing tax incentives focused on retirement and business innovation.
- ACA repeal and replace. There will be another attempt to replace ACA and replace it with a more market oriented healthcare plan
- Welfare reform. Republicans look to cut spending on welfare, which could come in the form of stricter work requirements and reduced funding to states.
- Capital gains. Index capital gains to inflation.
- Immigration. Develop a solution to Deferred Action for Childhood Arrivals (DACA), and allocate more money for border security and construction of a wall between the US and Mexico.
- Infrastructure. Increase infrastructure spending, but not necessarily resurrecting public-private partnerships.

Scenario Analysis

Base Case: Democratic House and GOP Senate

The base case scenario expected by betting markets is for a divided Congress. As of date 9/21/18, investors wagering in hypothetical election futures markets have priced in a 71% probability of a Democratic House and an equal 71% probability of a GOP Senate.



Source: Predictit.org, as of 21/9/18

Under this scenario, there are potentially two general paths.

- In the more optimistic path, there could be some middle ground between House Democrats and Trump. We could expect the budget cap to be increased. There is also scope for a modest increase of $200 billion in infrastructure spending. There may also be movement in criminal justice reform, paid family leave issues that have been promoted by Jared and Ivanka Trump, and addressing public health concerns, such as increased funding to tackle the opioid crisis.

- Under the more pessimistic path, we could see a stalled Trump legislative agenda, aggressive investigations of Trump and his inner circle, and finally the prospect of impeachment. This would poison the potential for common ground on policy.

Which path is taken depends on the many factors, including size of a Democratic majority, the outcome of the Mueller investigation, and demands from the hard left of the Democratic base. At the present, with polls pointing towards a divided Congress, the bias appears to be leaning towards the more pessimistic path.

Status Quo: GOP House and GOP Senate

Under this status quo scenario, the GOP would push to enact another round of tax reform (TCJA 2.0). This is more likely to succeed than repealing and replacing ACA. However, would likely be another close vote in the Senate. In addition, there is likely to be another attempt at boosting spending on border security that included funding for a wall along the US-Mexico border and hiring more customs and immigration officers. There are also proposals to reform welfare, which put stricter work requirements on welfare recipients. Finally, there could be changes to capital gains tax where it is indexed to inflation.

Complete Sweep: Democratic House and Democratic Senate

This is probably the most underestimated scenario. The market expects only a 29% probability of a Democratic takeover of the Senate, but it could be closer to 40%. History tells us that when there is a wave election, both branches of the legislature flip. Since 1952, every time the House has flipped (5 times) so has the Senate except once and that was in 2010. Given the large number of Red state Democrats, there is little room for error. Under this scenario, the Democrats will look to expand ACA, hike the minimum wage, introduce childcare/universal pre-K, attempt to reverse tax cuts for corporations and upper income families, and shift spending from defense to nondefense. It is highly unlikely any of the Democratic proposals will become law because they will not be able to muster the votes to override a Presidential veto.

Improbable Outcome: Republican House and Democratic Senate

This is the least likely outcome. There are many open GOP seats in the House, making most of them very competitive. This is not true for the Senate, where the environment is more favorable for the GOP with many incumbent Democratic Senators in deeply Republican States. In this scenario, we are likely to see a severely divided government. It is quite likely the GOP will suffer some losses in the House, which means the fiscally conservative Freedom caucus would push to keep fiscal policy tight. In the Senate, the Democrats would look to ease fiscal policy, leading to a classic stalemate.

White House

The prospects of gridlock with a divided government are high. With the Democrats likely to stymie the administration's agenda, what can we expect from the Trump administration?

- Presidential veto. The veto lets President Trump ensure that the Democratic agenda does not become law. It also makes it unlikely that any of the Trump legislation in the first two years, such as the tax bill, can be overturned.
- NAFTA and trade. The President has authority to unilaterally impose trade tariffs or sanctions, as he has on multiple occasions, affecting timber, washing machines, solar panels, NAFTA renegotiations, and China tariffs. With little prospect of accomplishing any new pieces of legislation, Trump may focus his attention on more trade issues such as additional tariffs on China, and target other countries, like Japan.

Foreign policy. This is also the domain of the executive branch. Repeatedly, presidents facing gridlock, or are a lame duck, turn overseas. The President may continue to focus on geopolitical hotspots, like denuclearizing North Korea, and continue to tighten the screws on Iranian sanctions. The President could also try to resurrect the Israeli-Palestinian peace talks, and roll back US involvement in Syria.

Investment Implications

Fixed Income

Under the base case scenario, the economic backdrop will remain robust, with an overheating economy and a rising negative output gap leading to upward inflationary pressures. With the optimistic path, the prospect of modest infrastructure spending would provide additional stimulus to an already booming economy. This could keep the Fed on its current protracted tightening cycle, and signal the potential to tighten beyond neutral. The size of the infrastructure spending and the state of the economy would determine the Fed's tolerance to a likely flat or inverted yield curve. We anticipate periodic overshoot in 10-year yields under this scenario, with more sustained trading above 3%. The Investment Grade (IG) and High Yield (HY) markets should tread water and clip a steady coupon.

However, under the pessimistic path of the base case, in the improbable scenario, and in a complete sweep, where gridlock prevails, the fading of the fiscal impulse could slow US economic activity to around trend by Q4 2019. This could cap the upward trajectory in consumer price inflation. The Fed should signal a pause or a slowing in its tightening cycle. Meanwhile, G-10 central banks could finally begin hiking interest rates, leading towards convergence in global monetary policy. This could lead to a broad-based rise in global yields and limit the potential for a sustained rally in US Treasuries. A slowdown in US growth, combined with market anticipation of sub-trend growth, could raise default concerns, and in combination, could lead to a selloff in the IG and HY markets. We would anticipate a similar market reaction to the status quo scenario where fiscal policy could be growth neutral. Any increase in border security expenditures would be offset by a cut in discretionary spending.

Equities

Under the gridlock situations (pessimistic path of base case, and complete sweep scenario), equity investors will not be able to rely on the GOP reform agenda to support higher equity prices. Instead, they investment views will be focused more on corporate earnings growth. While we believe US corporate earnings could grow 10% or more in 2019, the growth rate could be approximately half of what we expect in 2018 due to the absence of any additional tax benefits. In addition, there are also risks to this earnings forecast if higher than expected inflation, driven by tariffs and wage increases, reduce profit margins. For this reason, we would expect equity returns to be modest at best under a gridlock scenario.

However, under the base case scenario and status quo, equity markets could climb higher. Under the base case scenario, a pickup in infrastructure spending should offset some of the fading impulse from the last tax bill, thereby helping to keep US economic activity well above trend growth. In addition, infrastructure spending should boost the US infrastructure sector and global cement producers with US exposure. According to HSBC's *"US Midterm Elections: What to watch and what's at stake, Sept.5, 2018"*, a $30 billion per annum increase in infrastructure spending would boost 2019 civil engineering output close to 9pp and cement consumption close to 6pp.

Under the status quo - with Republicans maintaining control of Congress - the potential for additional tax reform, which could include a reduction in capital gains taxes, is the most bullish scenario for equity prices in the near-term, assuming earnings grow as expected and trade issues do not cause economic growth to slow.

US Dollar

The impact to the US Dollar (USD) from the midterm elections hinges on whether pro-growth fiscal policy measures are implemented. We see the USD appreciating under our optimistic base case scenario as the potential rise in rates above the neutral Fed funds rate should drive interest rate differentials in favor of the USD. Under the status quo scenario, further tax reform could lead to portfolio inflows into the equity and fixed income markets that would be USD positive. However, under the other scenarios (including pessimistic base case), we anticipate the USD to depreciate as we see the global monetary policy convergence theme dominating, and interest rate differential narrowing against the USD. The prospect of divided government should have a neutral impact on the USD. Going forward the USD will take its cue from the US monetary policy and economic outlook.

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