Do markets care about U.S. midterms?

OCTOBER 3, 2018 | By Kara Ng

As fall hits its stride, the looming midterm elections in the U.S. Congress are increasingly becoming a focal point for the nation. On Nov. 6, contests across the country will decide whether the Democratic party wrests control of the House of Representatives, the Senate or both chambers of Congress from the Republican party, which has held majorities in both since the 2014 midterms.

With predictions of a blue wave, a red wave and seemingly everything in between blaring from media outlets, it's worth stepping back and asking the question on many an investor's mind: Will the outcome of the elections actually matter for financial markets?

Our answer: Probably not.

Why? Pro-growth agenda already in place

We believe the results of November's elections are likely to have a muted effect on markets primarily because the most important items on the Republican party's legislative agenda have already been implemented. The tax bill of late 2017 (which ushered in sweeping tax cuts for businesses and individuals alike), the budget agreement passed in February and the series of regulatory reforms signed into law over the past year were all top priorities for the Trump administration and GOP leadership—and it's mission-accomplished for all three. Markets, as expected, have received the passage of each of these pro-growth measures favorably, as they've boosted corporate earnings and GDP (gross domestic product) growth

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With this in mind, it stands to reason that the only outcome that could really unnerve markets would be one that puts the future of any of these measures in doubt—in other words, a stunning Democratic takeover in both houses that would allow the party to unwind any of these policies via new legislation. **The bar for this is quite high, though.** Democrats would need to gain a two-thirds majority in the House and the Senate in order to enjoy a veto-proof majority that would prevent President Trump from blocking efforts to roll back any of these laws. Attaining this so-called *super-majority*, in our view, is almost entirely out of the question. The more likely scenario, from our vantage point, is that the Democrats win the House but lose the Senate. This would be in line with how the president's party has historically fared in midterm elections since the 1860s—the party occupying the executive branch has typically lost about 32 seats in the House.[1]

Furthermore, even if the implausible were to happen, we don't think that the Democratic leadership would gut either the tax bill or the budget agreement in their entirety. Rather, in our view, a more likely outcome would be the reallocation of some of the dollars behind either of the measures—but not a full-on withdrawal of funding.

In short, the key pro-growth measures that the Trump administration and GOP leadership championed for since Trump took office have already been signed, sealed and delivered. A change in the ruling party in one or both houses of Congress almost certainly can't undo this. Because of this, we believe markets are unlikely to bat much of an eye come Nov. 7.

Other considerations that could sway markets post-election

However, it's worth pointing out that the outcome of the midterms could still meaningfully alter the probabilities of what we call *second-order* considerations—policies or events that investors are likely to latch onto, albeit to a lesser magnitude than the recently enacted pro-growth measures. We see three main ones that could generate market noise:

- Impeachment
- Trade wars
- Infrastructure investment

Impeachment

Per the U.S. constitution, a simple majority in the House of Representatives is needed to impeach a president. Based on the latest polling[2], we believe it's likely that the Democratic party will gain enough seats to flip the House, thereby making the impeachment of President Trump a possible scenario when the 116th Congress convenes in January 2019.

However, it's important to note that impeachment and the actual removal of a president from office are two separate things. Under U.S. law, the House can bring forward impeachment charges against a president by a majority vote—but from there, it's up to the Senate to convict or acquit. A two-thirds majority in the Senate is required to convict and thereby oust a president from office. As mentioned above, this would require the Democratic party to achieve a *super-majority* in the November midterms—a very unlikely outcome, in our opinion.

This isn't to say that a conviction alone would be necessary to impact markets. In fact, we believe market noise would be a likely result, should the House take up impeachment proceedings —with several up-and-down moves possible in the days following. Yet, a look back at the market response to the impeachment of President Bill Clinton in December 1998 shows minimal overall impact. In fact, stocks actually climbed throughout the process (after bottoming out in October 1998).[3] More often than not, changes in economic and earnings fundamentals trump politics for financial markets.

Circling back to our earlier point, it's important to remember that Trump has already fulfilled many of the pro-growth promises he ran on during his presidential campaign. This is why we have a hard time fathoming a major selloff in markets no matter the end result of any impeachment process—including removal from office. *When it comes to Trump and markets, what's done has been done.*

Trade wars

Ever since President Trump first announced tariffs on steel and aluminum imports in early March—followed by tariffs against China later that month—fears of an all-out trade war have tested investors' nerves, as talks between the U.S. and other nations ebb and flow on a weekly basis. While Congress could theoretically pass legislation restricting the president's ability to slap tariffs on other nations[4], such a law would require a veto-proof majority in both the House and Senate in order to override a presidential veto from Trump. The bar for this is also quite high: two-thirds of members in both houses of Congress would have to agree to support such legislation. In line with our election-outcome thinking, this almost certainly means such a bill would need bi-partisan support—which we see as very unlikely.

However, we do believe there is one way the midterms could influence the degree of trade war rhetoric coming from the Trump administration—and that's via the impeachment process. As mentioned above, if the Democrats take the House in November, impeachment proceedings could be initiated next year. Were this to happen, we think the noise surrounding the process could divert Trump's attention away from protectionist policies. Given the degree to which markets have been rattled by trade threats over the past several months, this would almost certainly be welcome news, and would likely result in an incremental positive that would offset any market negatives surrounding impeachment.

Infrastructure investment

While running for office, President Trump made infrastructure improvement a centerpiece of his campaign, at one point calling for a plan to spend $1 trillion bolstering the nation's transportation network.[5] In February, he announced a specific plan that would use $200 billion in federal funds to spur roughly $1.5 trillion in infrastructure investments.[6] However, this plan has struggled to get off the ground, and the White House has since said the project won't hit the pavement (literally) until after the midterms.[7]

It's worth noting that both Republicans and Democrats are eager to tackle infrastructure, but there's been no agreement among the parties on how to pay for it. Assuming our leading election scenario wins out (Democrats take the House and the Senate stays in Republican hands), we believe that the resulting gridlock and polarization will make infrastructure improvements much less likely. On the lesser chance that the Democrats take both houses of Congress, they could pursue infrastructure as a legislative win, which would likely be a positive for markets. We think that Trump would probably approve whatever infrastructure package lands on his desk, given its pro-growth undertones, even if it wasn't precisely his design. This, in turn, would likely result in a market uptick.

The wrap

Ultimately, we believe that regardless of the outcome, November's midterm elections are unlikely to move markets in any significant fashion. The bulk of Trump's pro-growth agenda has already been implemented—and what transpires next month won't change this. The secondary factors we've identified that are likely to hinge on the midterm results—impeachment, trade wars and infrastructure investment—could create short-term noise in markets, but overall, we're not expecting them to amount to anything more than that. As we head into the heart of election season, we believe investors are best served by staying focused on their long-term objectives and not allowing any distractions, in the way of short-term market noise, to sway them off course.

[1] Source: https://www.nbcnews.com/politics/elections/everything-you-need-know-about-2018-midterm-elections-n832226

[2] Source: https://projects.fivethirtyeight.com/2018-midterm-election-forecast/house/?ex_cid=irpromo. As of Sept. 17, 2018.

[3] Source: https://www.marketwatch.com/story/stock-market-rally-could-keep-chugging-even-if-trump-were-impeached-2018-08-28

[4] Source: https://www.cnbc.com/2018/03/07/heres-how-congress-can-stop-trumps-tariffs–if-lawmakers-want-to.html

[5] Source: https://finance.yahoo.com/news/exclusive-trumps-newest-plan-spend-1-trillion-on-infrastructure-without-raising-taxes-130001535.html

[6] Source: https://www.whitehouse.gov/briefings-statements/building-stronger-america-president-donald-j-trumps-american-infrastructure-initiative/

[7] Source: https://www.cnbc.com/2018/03/29/trump-infrastructure-plan-will-likely-wait-until-after-the-midterms.html

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