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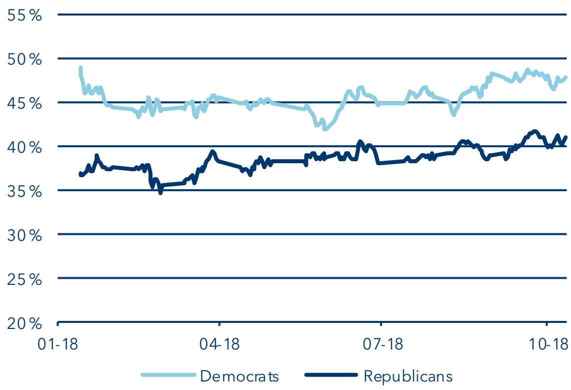
News from the financial markets

US midterm elections to determine Donald Trump's future political agenda

The policies of the American president are about to be put to the test. On 6 November 2018, the midterm elections will enable US voters to show how satisfied they are with the government's work. According to survey trends, there are no signs of a sweeping victory for the opposition: in the Senate, the Republicans are likely to retain the majority, whereas a change in leadership is likely for the House of Representatives. The following commentary delves into the potential implications of the election outcome on the financial markets.

Midterm elections are the halftime show during a president's four-year term of office. The law prescribes that about one third of the senators and the entire House of Representatives must be re-elected every two years. Voters often use the midterm elections to give the incumbent head of state a piece of their mind, which many times reflects their disappointment that so many promises have been disregarded in the day-to-day course of political posturing. Former president Barack Obama lost his Democrat majority in the House of Representatives as a result of the November 2010 midterms. This ultimately made it almost impossible for him to gain the necessary votes for his initiatives. It remains to be seen whether Donald Trump will experience a similar fate. In any case, the latest polls portend that a majority of Democrats will be seated in the House of Representatives when the dust settles. In national surveys, 48% of the respondents currently favour the opposition, while only 41% intend to vote Republican (see chart below).

National polls, House of Representatives: tendency of likely voters



Source: VP Bank, RealClearPolitics

A closer look at the details, however, reveals a much more diffuse lie of the land in the individual voting districts than the impression we get from the national polls. So it is necessary to shed more light on the specific groupings both in the Senate and the House.

Constellation in the Senate (upper chamber)

The Senate comprises 100 members. The leftist camp currently holds 49 seats (47 Democrats and two Independents), with the remaining 51, held by the Republicans. Thus the "blues" (in the USA, a political colour code has been accorded to the two major political parties since 2000, whereby blue stands for the Democrats and red for the Republicans) would only need to wrest two seats from the "reds" in order to gain a majority in the Senate. At first thought, this may seem easy, but in fact it is a difficult undertaking. Some background: While all members of the House stand for re-election every two years, Senators (who have six-year terms of office) are re-elected on a rotating basis, roughly one-third of the membership per election cycle – hence only 35 Senate seats are up for grabs this time. 24 of them (ca. 2/3 of the total) are currently held by Democrats and two Independents. Ten of these "blues" are running in districts that voted predominantly for Trump in the 2016 presidential elections. Thus the current opposition could actually lose seats in the Senate instead of gaining some. A continued Republican majority in the Senate is therefore very likely.

Constellation in the House of Representatives (lower chamber)

This chamber has 435 seats and, as previously mentioned, all of those representatives are running for re-election in the upcoming midterms. The Democrats would have to recapture 23 voting districts from the Republicans in order to achieve a majority in the House. If one is to believe the latest nationwide surveys, this seems like an easy hurdle to overcome. But a closer look especially at the 66 "battleground" districts reveals that the outcome is by no means clear. Here, registered Republicans account for 47% and registered Democrats for 46% of the electorate. Thus in light of the current political activism, a blue victory is surer than ever in the traditionally Democrat districts, while in rural regions the result is still entirely up in the air. The news portal FiveThirtyEight also incorporates the survey results from the state level in its calculation of the election outcome probabilities. Supposedly, despite the rather convoluted situation, the Democrats have an 85 % chance of winning the majority of seats in the House of Representatives. In our base scenario, we also take this likelihood into account.

Effects on the financial markets

A future majority of Democrats in the House of Representatives is now regarded as the most probable outcome of the midterm elections. Only in the event of clear voter shifts, whether in favour of the Republicans or the Democrats, could there be a significant knee-jerk reaction on the part of the financial markets. If it comes down to a result that is within the voting range predicted by the pollsters, this should have only a marginal effect on stock prices. But whatever the case, the election will indeed have a major impact on the legislative measures that require Congressional approval over the next two years. A blue majority in the House of Representative could stymie Donald Trump's unconventional regency. Although in the past amicable solutions were sought in such instances, today's deepened political rifts and the confrontational nature of the man in the Oval Office make cooperation with the opposition more difficult. It can therefore hardly be assumed that the president will succeed in passing laws with the blessing of the Democrats. But the Commander-in-Chief's trade policy would remain largely unaffected by the election result: as the imposition of punitive tariffs is (allegedly) based on national security interests, the White House can continue to work on the basis of presidential decrees.

Scenario 1: A Republican victory in both chambers

Were the "reds" to retain their majority in both the House and the Senate, this would be tantamount to a confirmation of Trump's policies. It would silence criticism within the rank and file and give the White House free rein. One of the items on the agenda would probably be a "Tax Reform 2.0" that affords even more relief, especially to the corporate sector. In addition, further deregulation of the financial sector is a likelihood, as is the continued easing of environmental requirements. The revenue shortfall associated with the renewed tax overhaul would increase the budget deficit and the national debt load. As to the latter, raising the upper limit should be no tough assignment due to the Republican majority in both chambers of Congress.

Interest rates and the dollar

Initially, these measures would be positive in terms of economic growth, but the risk of overheating would increase in subsequent years. The US Federal Reserve would be forced to tighten the interest rate screws even more than it has already signalled. Not only would the short end of the yield curve rise, but yields on longer-term Treasuries would also increase. The associated widening of the already sizeable interest rate differential between the US and the eurozone would argue for further USD appreciation.

Equity markets

As beneficial as the recent US tax reform has been for corporate profits this year, it is also controversial. An even further tax cut would likely accrue to the primary benefit of shareholders. At first glance this may seem positive for the equity markets, however the concomitant increase in financing costs and – due to higher wage costs – certain inflationary pressures would stand in the way of a continuation of the bull market over the medium term. Already today, conservative investors appear to be shifting from American stocks to US Treasuries. Every incremental interest rate hike enhances the relative attractiveness of US government bonds. Moreover, a successful continuation of the equity market uptrend that has remained essentially intact since 2009 requires broad international support. In short: Although a "Tax Reform 2.0" would initially help companies, consumers and hence the economy as a whole, rising interest rates would ultimately force the equity markets to consolidate in the further course of events.

Scenario 2: Democrats win a majority in the House

Democrats gaining a majority in the House of Representatives currently strikes us as be the most likely possibility. The latest surveys lead us to believe that a constellation in which the "blue wave" is strong enough to sweep through both chambers of Congress is improbable and we therefore are not inclined to examine that issue in greater detail. However, Donald Trump's governing work will already be severely hampered if his party loses a majority in the House. Many laws require passage by both chambers, including among other things further tax cuts. The latter would in all probability be off the table under this scenario. Trump would therefore have no other choice than to implement as many of his plans as possible in a watered-down form by means of presidential decree. Deregulations in the financial sector could be among them. Nevertheless, the Democrats would certainly do everything in their power to prevent Mr Trump from being re-elected in 2020, e.g. by calling for further investigatory committees. Political uncertainties would increase considerably.

Interest rates and the dollar

The political make-up of the two chambers would mean that the White House is hamstrung in its efforts to provide any additional economic stimulus and the Federal Reserve would be able to stay its course of gradual interest rate hikes. The upside potential for long-term Treasury yields could therefore be viewed as limited. If there is a more moderate tone in the trade dispute, this would give European companies more economic confidence again, this would be supportive for the euro - at least to a moderate extent.

Equity markets

Even if it becomes difficult for the government to provide fresh economic stimuli in the event of a political power logjam, this can actually have positive flow-through effects for the equity markets. Losses by the Republicans could rein-in Washington's heretofore disturbingly aggressive foreign policy, meaning that future successes would rather be achieved via a more diplomatic approach. The consequential planning certainty for industry would benefit the global equity markets. Why? In recent weeks it has become increasingly clear that companies are putting their investment projects on the back burner due to customs disputes. If confidence returns, this could be a step towards a calming of the current nervous market sentiment. In a more stable environment, Europe and emerging markets should be able to regain this year's valuation losses in the medium to longer term. Under such a scenario, the preferred sectors would be manufacturing, technology, financials and consumer cyclicals.

No effects on trade policy

Donald Trump's confrontational style and tactics will probably remain largely unaffected by the outcome of the US midterm elections. When it comes to foreign trade, the US president has extensive powers – so long as national security can be run up the flagpole as an excuse. He has a very broad interpretation of the latter.

A more even-tempered trade policy would probably only be achieved if the Republicans were to suffer significant losses. Traditionally, the party has stood for a liberal economic policy; a restrictive approach is not part of its worldview. Trump is therefore exposed to rebellion from within his own ranks, especially as it applies to harsh customs measures. So if the red camp were in fact to suffer major losses, the criticism would probably become even louder. In such a case, the man in the Oval Office would most likely have to adopt a softer tone of voice towards America's import and export partners.

Summary

If the election results are in line with the survey projections, we do not expect any immediate/significant market reaction. Only if either the Republicans or Democrats win in a landslide will the effect be more turbulent. So far, there is every indication that the "reds" will retain their majority in the Senate, while the leadership role in the House of Representatives will in future fall to the "blues". Thus the US President's political elbow room is in jeopardy of becoming narrower, in which case it will be difficult for the White House administration to force-feed America with new economic impulses. However, this scenario does not by necessity bode ill for the equity markets. A less aggressive foreign economic policy would bear the promise of more planning certainty for companies and a return of confidence in the United States as a trading partner.

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