



AA View: Only a small blue wave in the US mid-term elections

November 7, 2018

Summary

- Results so far point to a divided government, with the Democrats gaining control of the House of Representatives but with the Republicans increasing their majority in the Senate.
- The odds of extra fiscal stimulus through tax cuts have diminished.
- But trade disputes could well rumble on.
- The election results are unlikely to be the dominant factor in future asset market returns.
- Our transition environment view is unchanged.

Democrats take the House but lose ground in the Senate

In a rare occurrence based on recent precedence, the opinion polls and the markets correctly predicted the result of yesterday's US mid-term elections. With some results still to come in, the Democrats have so far managed to gain the necessary 25 seats in the House of Representatives to acquire control but have ceded seats in the Senate to increase the Republican's majority (see table below for the latest results, which are subject to change).

House of Representatives

	Result so far*	Previous
Republicans	199	240
Democrats	222	195

Senate

	Result so far*	Previous
Republicans	51	51
Democrats	45	49

*Several races still to declare

Equity market reaction tentatively positive - a short-lived relief rally is possible

At the time of writing (5.30am EST, 10.30am GMT), US equity market futures are up moderately – the S&P mini contract is up 0.9% - whilst global equities have been gaining so far. The Eurostoxx 50 index is up 1.3%, for example. At the same time, volatility has fallen back as well, with the commonly tracked VIX index touching 17 from yesterday's level of 20. Meanwhile, benchmark US yields have fallen back a touch, with the 10 year Treasury yield falling by 5bps to 3.18% and the 2 year yield falling by 2bps to 2.92% so far today. In terms of the currency, the US dollar index has fallen by 0.55% today but it should be noted that the dollar has been on a weakening trend since the start of this month and has fallen by almost 1.5% since November 1st.

US dollar fall since the mid-terms is merely a part of the November move



In terms of equity market moves, the tentative rally is not surprising since one major source of uncertainty has been removed with the mid-term election results. Indeed, the US equity market has rallied in the year following each mid-term election since the Second World War, so an extended relief rally this time around is possible. However, we would caution that the length and extent of any rally this time around may be quite limited given the current challenges facing global equity markets.

Results imply less fiscal stimulus next year

One reason why any sort of relief rally may be short-lived is that the chances of extra fiscal stimulus in the shape of further tax cuts or making current tax cuts permanent seem to have diminished with a Democrat-controlled House. At the same time, the maximum positive impact of the current tax cuts is likely peaking now and the future stimulus to the economy is likely to fall throughout 2019.

There is one potential source of offsetting stimulus, however. An area in which there has been bipartisan support is infrastructure spending, where both parties have been talking up the need to improve transportation networks, bridges and broadband, for example. So an infrastructure spending bill may still be passed. On the other hand, some politicians may calculate that injecting extra stimulus to the economy in the run-up to the 2020 Presidential elections may hurt their party's chances.

All in all, we think that fiscal stimulus is likely to fade in 2019 in net terms. Indeed, the initial bond and currency moves may be the market reacting to such a prospect.

The most important market drivers have not changed

Whilst the results of the Mid-Terms may well have a large impact on domestic politics, we believe that the most important drivers of market returns over the coming year have not changed.

These include:

- **Continued reduction in monetary policy stimulus:** The Fed is likely to signal another interest rate increase in December when it meets this week and it is likely that monetary policy will continue to be tightened throughout much of 2019 too. At the same time, other central banks are in tightening mode too, including the European Central Bank, which is scheduled to end its current Quantitative Easing programme in December, and the Bank of Canada, which raised rates twice over Q3 and is likely to continue tightening in 2019.
- **Trade disputes:** Despite the divided US government, one area where the President will continue to have power is in foreign policy and with the setting of trade tariffs. With this in mind, the current dispute between the US and China will not suddenly end with the change of power in the House of Representatives. Recent talk has been of some form of trade agreement between President Trump and Chinese President Xi Jinping in the upcoming G20 summit in Argentina on November 30th but much remains unresolved and we cannot be certain that a deal will be reached to alleviate the headwinds that have blown through emerging markets this year.
- **Narrow market leadership:** As October's market correction showed clearly, equities are still being led up and down by a narrow set of stocks that are primarily in the technology sector. With very lofty expectations for earnings, even small misses can lead to risk aversion by investors.

Our transition environment theme is unchanged

Overall, we do not see any reason to alter our view that the transition environment for assets will remain in place. As a reminder, this is our view of a phase in markets that will see a gradual shift away from the

outperformance of risky assets towards fixed income, with more frequent bouts of volatility. Non-market risks were apparent and important before the mid-term elections and they continue to be after them. The US economy is still likely to lose momentum next year, in our view, with ongoing monetary policy tightening, rising yields and late cycle dynamics leading to capacity constraints and rising inflation. Now we can add the prospect of

lower new fiscal stimulus to the fading impact from current tax cuts.

We, therefore, continue to recommend that investors look to reduce portfolio reliance on equities but on a gradual basis and in times of market calm, whilst also understanding that reducing portfolio risk may also mean giving up some short-term gains.

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