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Midterm Elections: How Will Markets Respond?

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Key Takeaways:

- The markets expect a split Congress, but there are two other possible outcomes investors should prepare for.
- Different sectors, such as energy or healthcare, could get a boost depending on election results.
- Remember to focus on the long-term, not the short-term volatility the midterms might cause.

The U.S. midterm elections are right around the corner, bringing with them a sense of uncertainty about how the results might affect the markets and investment portfolios. Will the outcomes add fuel to a rather volatile market environment? Or will it be a more muted response? Historically, the impact of these elections tends to be short-lived, but the magnitude of the market reaction is often meaningful over the remainder of the year.

Let's take a closer look at the three possible outcomes and what they might mean for the markets, different sectors and the economy.

A split legislature

With all of the House seats and one-third of the Senate seats up for grab, most polls are pointing toward a Democratic House and Republican Senate as of October 17. If this happens, we expect an overall ambivalent reaction because the markets seem prepared for this outcome. The economic momentum that began in the middle of 2017 should not be affected and may even be enhanced. Here are some other issues to watch:

- **Infrastructure.** Expect an infrastructure spending initiative early in the new term. It's been a priority for the Administration and appears to have bipartisan support. This initiative would benefit many industries and sectors, including project management firms, engineering and construction companies and providers of raw materials. The commodities complex, especially the industrial metals subsector, could also experience price increases.

- **Taxes.** Although the President would like to see legislation indexing the capital gains tax rate to inflation, there likely won't be any outright tax cuts.

- **Trade.** The imposition of punitive or retaliatory tariffs is an executive branch decision. A split Congress is not likely to interfere with the Administration's trade policy.

Democratic sweep of both houses

If the Democrats win control of Congress, the initial market reaction might be quite negative. Why? This outcome is currently underpriced in the markets and could also be viewed as an overall indictment of the President's economic policies. It may be appropriate to restructure portfolios a bit more defensively under this scenario. Although, some people believe this type of "gridlock" could ultimately be good for investments because it will be difficult for the government to have any impact on the economy and markets. Other implications could be:

- Infrastructure. As with the first scenario, an infrastructure spending bill is likely. However, Congress may want to decrease defense spending to pay for this initiative.

- **Taxes.** Without a veto-proof majority, Democrats may be hard-pressed to unwind recent tax cuts. Congress could potentially use the upcoming debt ceiling negotiations as a bargaining chip to extract tax increases from the Administration.

- **Trade.** Congress would likely agree with the Administration's hard-line stance towards China. If so, the resulting dollar strength could put further pressure on emerging markets.

- **Deficits.** After the midterms, presidents tend to worry about their re-election and often push aggressive fiscal spending programs to garner votes. Deficits may become even more entrenched in this gridlock environment. Increased issuance of Treasury debt to finance these deficits would drive interest rates higher and possibly "crowd out" private debt issuers—dampening economic growth.

- **Healthcare.** This sector, particularly the pharmaceutical companies, could be subject to greater drug price controls. The President has broached this issue for the last two years.

- **Energy.** Alternative energy initiatives would likely be proposed although ultimate Administration support would be questionable. These initiatives could have a negative effect on the fossil fuel energy sectors.

- **Business.** The greater likelihood of increased minimum wage legislation would hurt low-end retailers.

Our Perspective

At face value, this is a much more market-friendly election outcome. Pro-business tax and regulatory policies would continue unabated. Plus, it would likely help small- and mid-cap stocks; these businesses generally have higher tax rates and suffer more under regulatory burden. Other sectors potentially impacted include:

- **Traditional energy.** The Administration favors this industry and is skeptical of proposals to fight climate change. Also, logistical bottlenecks could possibly loosen with greater pipeline construction.

- **Healthcare.** There may be a renewed push to repeal the Affordable Care Act, which could negatively impact the hospital and insurance companies that have come to rely on payments from this program.

- **Financial service.** These firms would generally benefit from continued relaxed regulatory policies.

- **Education and prisons.** For-profit education firms, prisons and student lenders would face less regulatory scrutiny.

- **Military.** Defense spending would continue to be a priority.

Looking at the big picture

Whenever we delve into discussions about politics, it's important to consider the current economic environment and try to determine the actual impact an election or any political pronouncement would have on it. We know the midterm elections will have consequences for financial markets. What we're closely monitoring is whether the ultimate impact will be enough to derail the long U.S. economic expansion and equity bull market.

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