

Midterm madness and markets

A special report by the Portfolio Advisory Group

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Tasneem Azim-Khan, CFA
tasneem.azimkhan@rbc.com

The U.S. midterm elections are in less than a week, and we believe there has been considerable anxiety amongst voters and investors alike regarding potential outcomes. Such anxiety is somewhat understandable given markets inherently dislike uncertainty, and we believe the feeling of ambiguity is amplified in the context of a cycle that many worry has become unsustainably long in the tooth (though we take issue with the word “unsustainably”). We would also go as far as to opine that this anxiety fed into the approximate 7% market correction we saw in October.

Investors’ focus should remain on the health of the U.S. economy, alongside the outlook for EPS growth, in our opinion. On the former, we do not expect changes to Congress to shift the course U.S. economic growth, which is expected to be about 3% in 2018 and 2.5% in 2019 (modestly above the average pace of growth over the last decade), according to RBC Capital Markets. EPS growth forecasts of 19% and 9% in 2018 and 2019, respectively, by RBC Capital Markets are above the average EPS growth since 2011. Furthermore, based on what we have seen of market performance in previous midterm election years, we would use periods of market volatility leading to the election to opportunistically add to high-quality stocks that have hitherto been out of reach due to elevated valuations.

Likely outcomes: Congress is having control issues

Next week Tuesday (November 6), U.S. voters will be arbiters of the fate for 35 of 100 Senate seats, 36 of 50 governorships, and all 435 seats in the House of Representatives (House).

Republicans hold 237 House seats, Democrats 193, and there are five vacancies. Thus, the Democrats would need a net gain of 23 seats to recapture control of that chamber. In this regard, the consensus seems to be that the House has a high likelihood of switching to Democratic control. Indeed, prediction markets such as FiveThirtyEight, the Iowa Electronic Markets, and PredictIt see about an 85%, 78%, and 70% chance, respectively, that the Democrats will gain control of the House.

Prediction markets expectations

Forecaster	Likelihood Democrats win...	
	House	Senate
FiveThirtyEight	85%	15%
Iowa Electronic Markets (IEM)	78%	27%
PredictIt	70%	13%

Source - PredictIt, FiveThirtyEight, Iowa Electronic Markets

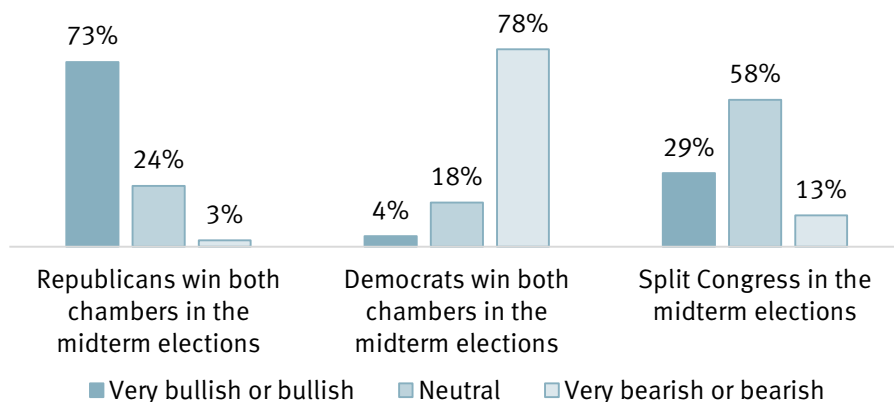
Another useful predictor that has been used in the past has been the “party of the president”.

The situation in the Senate is different. Republicans hold a slim 51-49 majority, yet it is likely that the GOP will defend its control because, of the 100 Senate seats, 35 are up for election, 26 of which are held by Democrats. So, the Democrats are under more pressure to maintain those 26, but also flip the nine Republican-held seats that are up for grabs. This is no small feat, especially given that 10 of the 26 Democrat-held seats at stake are in states that President Donald Trump carried in the 2016 presidential election.

Another useful predictor that has been used in the past has been the “party of the president”. Since WWII, the sitting president’s party has lost an average of 25 seats in midterm elections. In this regard, investors should take some comfort in the fact that such a change across Congress is not unusual. Furthermore, the popularity of a sitting president is also relevant. Based on research from JP Morgan, when the presidential approval rating is below 50%, the number of seats lost is 37; above 50%, it is 14. President Trump’s approval numbers have recently floated around 40%, giving hope to Democrats.

Of the three possible election outcomes—the GOP maintains control over both legislative chambers, Democrats gain control over both chambers, or the consensus/base case that the Democrats take the House while the GOP wins the Senate—the second outcome typically gives investors the greatest concern. We opine that this may be because Democrats tend to be perceived as less business friendly (though not necessarily) than Republicans, and would look to pursue a more partisan, progressive agenda.

What are the implications for each of the following?



Source - PredictIt, FiveThirtyEight, Iowa Electronic Markets

Setting aside what we think is the low likelihood Congress becomes majority Democrat, and irrespective of whether the Democrats control one or both chambers, we still believe either outcome is unlikely to have any meaningful economic impact. This is because any new legislation would have to be passed by both the House and Senate, and not be vetoed by the president, a Republican. Similarly, in the more likely event that the GOP and Dems control the Senate and House, respectively, the former would face an uphill battle with respect to passing new legislation given the latter holds veto power.

Midterms and the U.S. economy

We do not believe the midterm election results will break the pace of economic growth in the U.S. Indeed, we have yet to see any GDP growth downgrades in light of the midterms. RBC Capital Markets adheres to its GDP growth estimates of about 3% in 2018 and 2.5% in 2019, representing a faster pace of economic growth versus Canada, the eurozone, U.K., and Japan.

Historically, federal government policy has had macroeconomic implications to the extent that the outcome affects the overall level of taxation in a meaningful way.

Historically, federal government policy has had macroeconomic implications to the extent that the outcome affects the overall level of taxation in a meaningful way. In this regard, we believe that concerns that a greater Democratic presence in Congress could lead to a reversal of the tax cuts instituted at the beginning of 2018, are overdone. President Trump and the Republican majority in Congress already achieved their key objective with respect to taxes at the beginning of the year with the passing of the Tax Cuts and Jobs Act (TCJA). To be clear, the TCJA has a number of provisions that will sunset in the future and at some point Congress will have to decide whether or not to extend some of these temporary aspects. But under current law, the bulk of these provisions do not expire until 2025, and as such we are not concerned that the TCJA will be clawed back meaningfully, even in the unlikely event Democrats occupy both chambers after the midterms. Again, any attempts to undo Republican policies will no doubt be met with a veto by the president, in our opinion.

That said, looking ahead, we believe there is a possibility the Trump administration would be more inclined to roll out additional fiscal stimulus à la TCJA part deux, particularly in the context of the 2020 federal election. Under such a scenario, a Democrat majority in Congress is not likely to let such legislation pass.

In contrast, should the Republicans control Congress, we believe additional fiscal stimulus in the form of more tax cuts is far more likely. Such an event would likely extend the outperformance of U.S. economic growth, versus its global peers, at least in the short-to-medium term. Yet another fiscal boost would have meaningful implications for the Fed's interest rate policy i.e., we would expect the interest rate differential between the U.S. and its developed peers to persist for longer as the Fed may consider an extended and/or more aggressive rate hike path in the context of a stronger-for-longer expansion. Following from this, one could surmise that the prospects for persistent strength in the U.S. dollar are higher under a Republican-controlled Congress versus one that is Democrat-controlled.

To the extent that we have a split-Congress scenario, the prospect of TCJA part deux is still somewhat uncertain given that 60 Senate votes are required under current rules for such legislation to pass.

Under any of these outcomes, we believe there is potential for a sizeable infrastructure bill to be passed given that such spending tends to have bipartisan support. Indeed, both Hillary Clinton and Donald Trump campaigned on greater infrastructure spending leading up to the 2016 presidential election. Earlier this year, President Trump outlined an infrastructure plan for US\$200B in government funds over a 10-year period. However, the plan had little detail around how such spending would be

financed, which could be a source of contention between Republicans and Democrats in the passing of a bill.

Trade policy: U.S.-China trade war

It is important to keep in mind, that Congress does not have much of an ability to control trade policy, as the Oval Office has power to act unilaterally. Still, in our view, the outcome that could increase the threat of protectionism would be the GOP taking both chambers of Congress. The Trump administration could take a harder stance towards trade with China through its “America First” policies via rising tariffs, and could adopt a similar approach with other key trading partners, e.g., Europe. Essentially, this scenario increases the risk of a global trade war, in our view, and subsequently amplifies the risk of a global recession. One mitigating factor, though likely more short-to-medium term in nature, could be a boost to fiscal stimulus by a GOP-controlled Congress (as discussed above).

It should be noted that U.S. concerns regarding trade relations with China pre-dated the Trump administration.

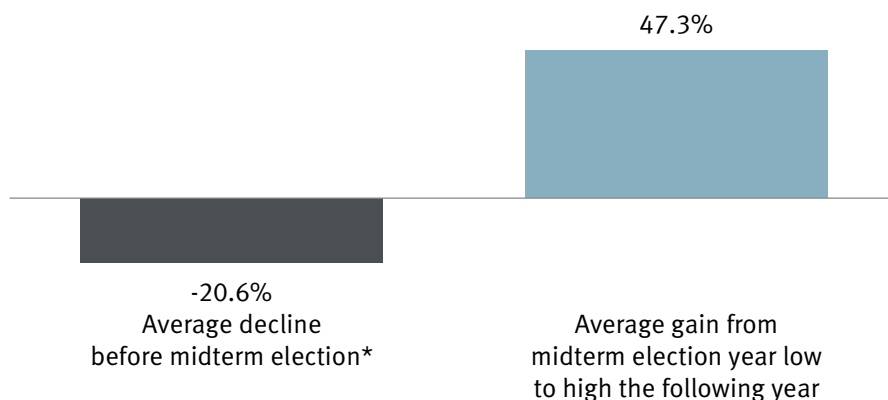
It should be noted, however, that U.S. concerns regarding trade relations with China pre-dated the Trump administration. In particular, the protection of U.S. intellectual property, the desire for greater access of foreign companies into China, and China’s manipulation of its own currency have long been contentious issues. In other words, the antipathy towards trade relations with China seems to be bipartisan. Furthermore, we believe Democrats will likely do themselves no favors by defending China or visibly promoting free trade as the aforementioned concerns have yet to be addressed, let alone resolved. Still, we believe that in the event the Democrats occupy one or both chambers, there is a possibility trade protectionism de-escalates in particular should the economic costs increase.

Midterms and the market – Historical precedent

The Portfolio Advisory Group has written prolifically about the imminent midterms in the *Global Insight Weeklys* dated [May 24, July 19](#), and [August 9, 2018](#). Based on the research of previous election cycles, we know that the U.S. market typically corrects in the 12 months leading up to the midterm election. Such volatility is par for the course as the market inherently dislikes uncertainty. Indeed, based on S&P 500 returns

Corrections are common in midterm years, and so are follow-on rallies

S&P 500 returns surrounding midterm elections (1934–2014)



Performance before and after 21 midterm election years, measured from the peak within 12 months before the midterm election year low, to that low. Source - RBC Wealth Management, Bloomberg

surrounding midterm elections between 1934 and 2014, the S&P 500 corrected by an average of 20.6% over the 21 instances.

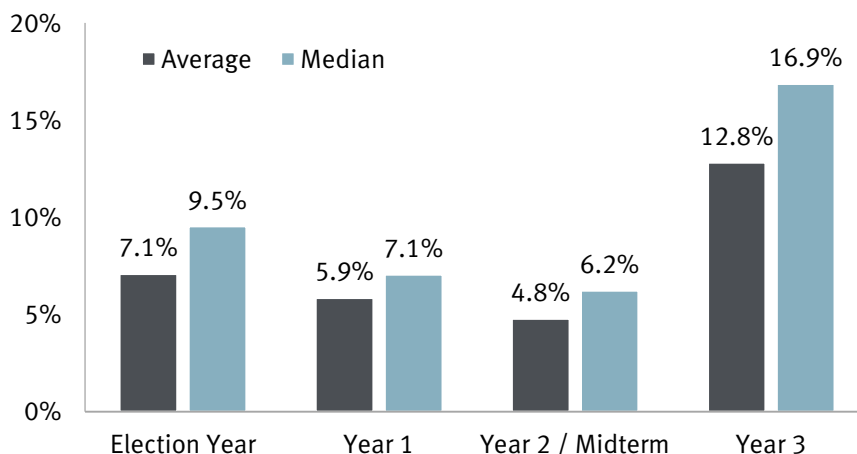
In this regard, 2018 has been no exception. The approximate 10% correction from late January to early February remains rife in investors' minds. More recently, we saw an approximate 7% correction in early October. While it's not clear what the primary driver of that volatility was, we would think angst related to the midterms contributed to the negative sentiment.

While the equity market performance leading up to the midterms is less than ideal, we believe what happens after the midterms matters. In that regard, the U.S. market demonstrates better performance after the midterm election year low has been established. In fact, based on our research, the S&P 500 rallied 47.3% on average, as measured from the low point reached during the midterm election year to the high in the following year. In all of the 21 instances since 1934, the market traded higher.

In addition, RBC Capital Markets' analysis of election cycles (during the four-year period from the election year, to one year after the midterms) since 1928 suggests a similar pattern. While there are stock market gains

While there are stock market gains during midterm election years, they tend to be far below those seen in the other years.

Average and median S&P 500 performance during election cycles since 1928



Source - RBC U.S. Equity Strategy, Bloomberg

during midterm election years, they tend to be far below those seen in the other years. In fact, stock market performance tends to be superior during the year after the midterm year versus the three years prior.

Note that the directional changes in performance have not always occurred immediately after the midterms, so we could see more market volatility before we see a rebound later, often weeks or months later.

Still, all said, it would seem that based on historical precedent, one should look beyond the noise related to the midterms and opportunistically use such volatility to add to high-quality stocks that hitherto have been out of reach due to a run-up in valuations.

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Author

Tasneem Azim-Khan, CFA, Portfolio Advisor
tasneem.azimkhan@rbc.com; RBC Dominion Securities Inc.

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