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US midterm elections: Return of political gridlock?

High inflation may sap support for Democrats, making policy-making more complicated

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FLASH NOTE

SUMMARY

- Current polling suggests the Democratic party could lose its House of Representatives majority in Congress in the November mid-term elections.
- High inflation is a millstone around the neck of Democrats, especially as incomes have not caught up with price increases.
- A gridlocked Congress could complicate policy responses and delay much-needed support in the case of a hard recession (not our main scenario).
- The elevated political polarisation in the US could mean more battles around debt-ceiling deadlines and federal budget rollovers if the Republicans re-take the House.
- The Federal Reserve is likely to keep tightening monetary policy after the midterms as it continues to focus on stubborn core CPI inflation and resilient employment growth. The risk of a policy error is high given the lagged effect of interest-rate increases on GDP growth as well as the evaporation of market liquidity due, in part, to quantitative tightening (QT).
- Historically, equity markets tend to see a midterm boost after the elections. But this effect fades if one looks in isolation at election periods when the Fed is in rate-hiking mode.

DEMOCRATS' CHANCES IN HOUSE ARE LOW

The US midterm elections take place on Tuesday, 8 November. **The entire House of Representatives is up for renewal as is one third of the Senate** (there are two senators for each US state, and they have staggered six-year terms). There is also a myriad of state and local elections on the same day, but they are of lesser importance for financial markets.

The midterm elections generally obey a constant of political gravity whereby the **party in power loses seats in the House of Representatives**. This is simply

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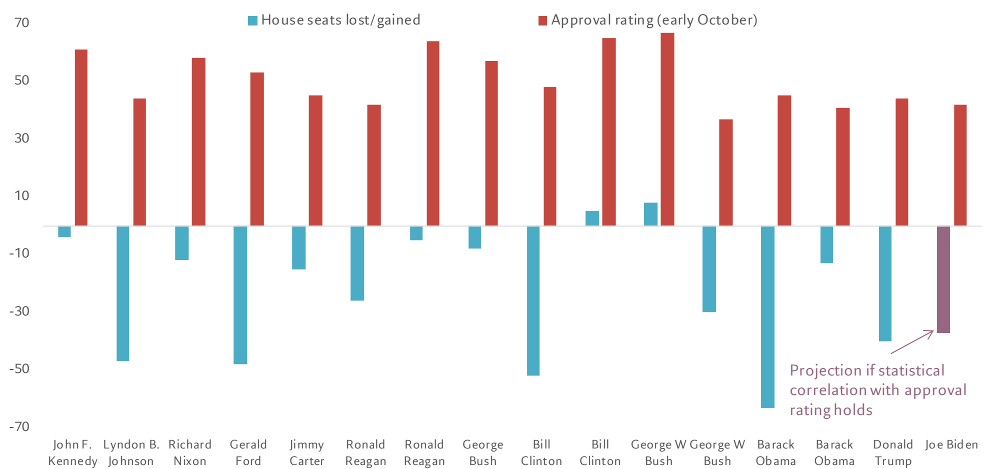
because an electorate galvanised two years earlier by the presidential election becomes less motivated. Put differently, electoral support for the party of a sitting president tends to sag by the time of the midterms. **On average, the president's party loses 23 seats in the House at midterm elections** (according to data going back to John F. Kennedy's presidency at the start of the 1960s). Moreover, the number of lost seats tends to be a function of the president's approval rating going into the midterms.

If this statistical pattern holds, the Democratic party is on track to lose 37 House seats (president Joe Biden's approval rating is currently a rather modest 42%, see *chart 1*).

Chart 1: President Biden's so-so approval rating going into the midterm elections



Source: PWM CIO Office & Market Research, Bloomberg Finance LP, 25 October 2022

Recently, political observers have theorised that this summer's Supreme Court decision to overturn the constitutional right to abortion (at the federal level) could fire up the Democratic base and upset the usual pattern of midterm elections. But recent polling suggests the impact of the abortion decision may already be wearing off.

Moreover, we believe that **the economic backdrop could hinder the Democrats' attempts to maintain their slim majority in the House of Representatives**. Inflation is stubbornly high, with headline inflation (including food and energy) up 8.2% year-on-year in September. Wage growth has not kept pace, with inflation-adjusted personal income in September 4.5% lower than a year before.

In short, **the Democrats will likely find it hard to maintain their narrow majority in the House of Representatives.** The influential FiveThirtyEight model lately put the odds of Republicans achieving a House majority next month at 81% (as of 25 October). The Senate race is less clear cut. FiveThirtyEight puts the probability of the Democrats keeping a majority there at 55%. The focus will be on especially competitive senatorial races in Nevada, Georgia, Pennsylvania, Wisconsin, North Carolina and Ohio.

It is quite likely that the elections will result in **congressional gridlock**, meaning that no major legislation will be enacted before the next presidential election in two years' time. Usually, **this is a scenario that financial markets like** since it means limited interventionism in the economy *(see last section).* But this time

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could be different as the economy is slowing (with sizeable downside risks for 2023). Gridlock means fiscal support could be delayed and the economic contraction exacerbated, meaning the US falls into a hard recession (although this is not our main scenario for now). Furthermore, in a divided Congress, decisions on lifting the debt ceiling or approving the annual federal budget could once again become flashpoints, especially in view of heightened political polarisation. **Some Republicans have already stated their intention to focus intently on debt and spending deadlines if they win a majority in the House.**

Alternatively, the Democrats could end up confounding the opinion polls by keeping their majority in the House and expanding slightly their majority in the Senate. In this scenario, president Biden could return to unfinished business, and try to press forward again with the remaining parts of the USD3.5 trn 'Build Back Better' plan he touted in 2020 (and stymied over the past two years by dissension among Senate Democrats). Apart from spending, a strengthened Biden administration could also look at the scope for **higher taxes on corporates and wealthy individuals as well as on corporate share buybacks**.

At the same time, the turmoil caused in UK financial markets by the announcement of bold fiscal stimulus may serve as a warning to governments worldwide, with the proverbial 'bond vigilantes' more attuned than ever to any whiff of increased spending and additional budget deficits.

After the midterms, the focus will likely immediately shift to the 2024 presidential election. President Biden said on 23 October that he "intends" to run again while former president Donald Trump said he "will probably have" to run. A Harvard Caps-Harris poll released on 17 October showed that Trump had a two-point lead over Biden in a hypothetical matchup (the same poll shows that 55% of Republican voters would back Trump for re-nomination, a sign of his popularity in the Republican party; Florida governor Ron DeSantis is polling at 17%).

NO IMMINENT FED PIVOT

Midterm elections are unlikely to mean much for the Federal Reserve (Fed) in our view, as it remains guided by economic data and its fear that inflation expectations become unanchored. In other words, even though it is true that pre-election political pressure may have a role in the Fed's recent hawkishness, **we do not necessarily expect a pause in rate hikes straight after the midterms**.

The Fed continues to concentrate on backward-looking data such as high core CPI inflation and resilient monthly job growth numbers. At the same time, it is monitoring surveys like the University of Michigan's consumer sentiment survey for insight into consumers' inflation expectations. These remain stubbornly high, with the preliminary October survey showing respondents expect annual consumer inflation to be 5.1% over the next 12 months.

Bottom line is that **we think the Fed will deliver another 'jumbo' 75bps rate hike at its next meeting on 2 November,** six days ahead of the midterms. There are rising risks that the Fed will raise rates by a similar amount again in December, especially given the ongoing inertia in inflation data (our 2023 scenario for the Fed rates is currently being fine-tuned). Once again, payroll data and core consumer price index data will be key. But we would probably need two or three pieces of data heading in same direction before we see an inflection in Fed policy. In short,

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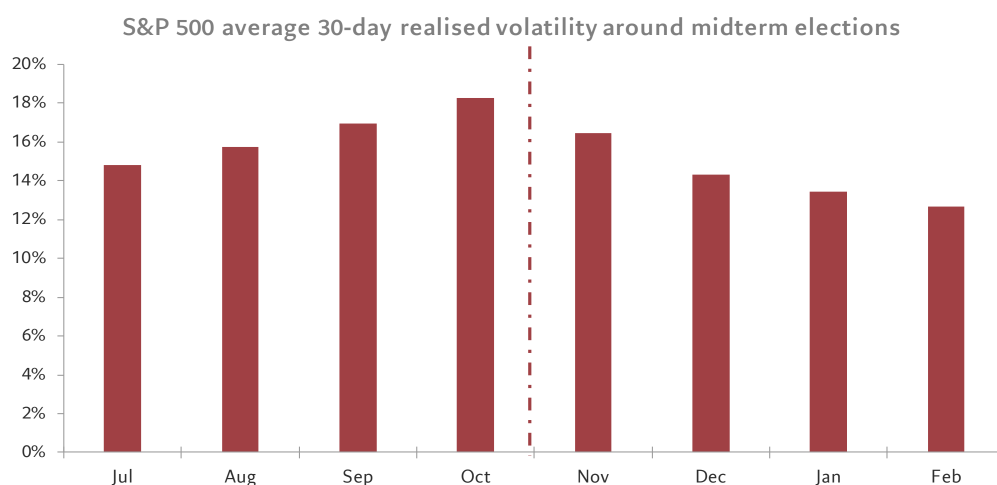
we do not think a policy pivot is imminent. Nonetheless, the pace and size of rate hikes already risks depressing demand in the US economy more than is needed to contain medium-term inflation and causing liquidity problems in financial markets, in our view. In other words, the danger of a policy mistake should not be underestimated.

EQUITY PERFORMANCE AROUND MIDTERMS: IT DEPENDS ON THE FED

Based on 60 years of data, **markets tend to perform better after midterm elections than before**. The average price return for the S&P 500 is 19.8% (in USD) in the 12 months after midterm elections, versus +4.4% in the 12 months before.

Realised equity market volatility tends to rise ahead of the midterms and to fall thereafter *(chart 2)*.

Chart 2: Historically, equity market volatility has tended to spike around the midterms



Source: PWM CIO & Market Research, Bloomberg Finance LP, 25 October 2022

Equity markets have tended to perform better after the midterms when rival parties control the presidency and Congress than when the two branches of power are under the same party's control. The average one-year gains post-midterms are +15% versus +14%, respectively. Excluding recession years, this +1% performance gap widens to +4% when Congress is split or controlled by the party opposing the sitting president.

There is, however, an exception to these historical trends worth remembering this time around: statistical analysis suggests that w**hen the Fed is in hiking mode, there is no tangible midterm boost to equity markets, whatever the outcome** ***(chart 3)***.

We expect the Fed to remain hawkish in the near term due to the resiliency of US data (at least the resilience of data sets scrutinised by the Fed) as well as the stickiness of consumer inflation expectations. We would argue the bar for the Fed to cut interest rates is even higher, given the Fed is probably anxious about the risk of a resurgence in inflation.

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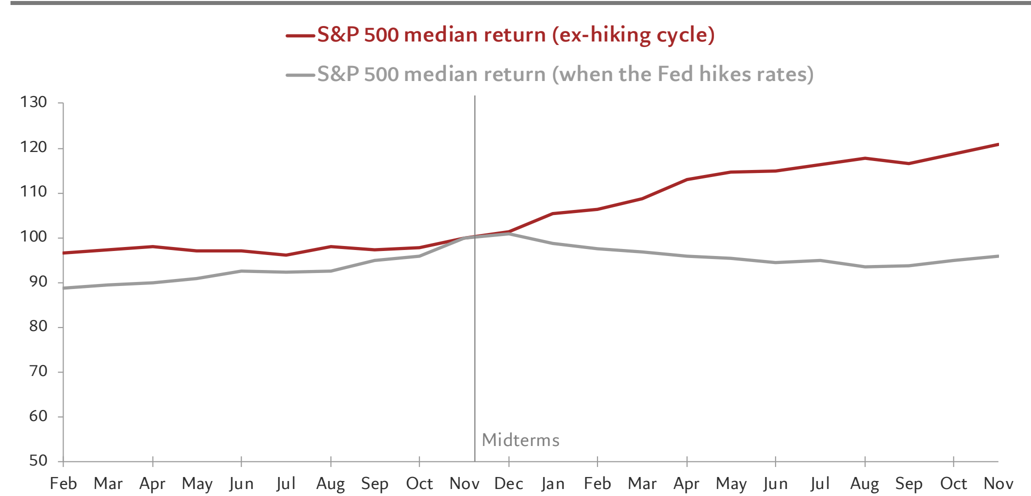
Bottom line, we do not think the midterms will have a significant impact this time around on the performance of the US equity market. We will continue to watch a host of other factors, including monetary policy, global geopolitics and stress in some local energy markets.

Chart 3: Historically, markets tend to rally after midterm elections… except when the Fed is in hiking mode



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APPENDIX: MARKET PERFORMANCE BASED ON POLITICAL CONTROL OF CONGRESS

All cases

White H.	Congress (vs. WH)	GDP	GDP deflator	S&P 500	USD
D	Split	2.0	1.9	13.6	3.5
R	Split	3.2	3.9	13.7	1.8
D	Unified	3.8	2.8	11.7	1.3
R	Unified	2.6	3.7	3.0	-2.1

Fed in hiking cycle

White H.	Congress (vs. WH)	GDP	GDP deflator	S&P 500	USD
D	Split	NA	NA	NA	NA
R	Split	4.6	3.9	4.6	4.6
D	Unified	4.3	3.2	6.1	2.0
R	Unified	1.3	3.9	0.7	-2.4

Fed pausing or cutting interest rates

White H.	Congress (vs. WH)	GDP	GDP deflator	S&P 500	USD
D	Split	2.0	1.9	13.6	3.5
R	Split	2.0	3.9	13.2	0.3
D	Unified	3.0	2.2	20.2	0.4
R	Unified	3.0	3.9	0.7	-1.9

Note

D: Democrat R: Republican WH: White House (presidency)

USD data since 1972 (DXY index), other since 1960. Based on annual data.

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