



THE DRIVE YOU DEMAND

US CONGRESSIONAL ELECTIONS NOVEMBER 2018

Spotlight

Key points

- ◆ *US Congressional elections are set to take place on 6 November.*
- ◆ *It seems unlikely that any of the potential outcomes will change the trajectory of US policy on trade and tariffs.*
- ◆ *A Republican sweep of both houses of the US Congress could bring fiscal stimulus and renew upward pressure on US interest rates.*
- ◆ *Even a Democratic success across both houses of Congress would be unlikely to result in the removal of the sitting President.*
- ◆ *A Congressional split or a Democratic sweep pose asymmetric risks to markets.*
- ◆ *Capital-protected strategies and hedge fund exposures continue to be valuable to investors in the current environment.*

With October's dramatic declines in markets, it has been easy to overlook the fact that the United States will hold Congressional elections next week. Having met with a range of investors in three continents during September and October, hope exists that some form of Democratic victory can staunch the aggressive domestic and international policy agenda of the Trump administration. Politically, however, we see limited prospects of this happening, irrespective of the outcome of the vote on 6 November.

The latest polling indicates the most likely outcome is for the Democrats to regain control of the US House of Representatives (84% probability as per fivethirtyeight.com) with the Republicans keeping their majority in the US Senate (83% probability as per fivethirtyeight.com). Of course, polling predictions can carry their own risks as seen in the Presidential elections of 2016.

It therefore feels prudent at this stage to explore the implications of four potential outcomes for the 6 November elections and their broader potential consequences for US politics, policy, and markets looking ahead.

US Congress splits between Democrats/Republicans

Based on polls, the most likely outcome (70% probability as per fivethirtyeight.com) is for split control of the US Congress with Democrats taking the House of Representatives and Republicans controlling the Senate.

Politically, control of the House of Representatives would enable Democrats to begin impeachment proceedings

against President Trump. However, investors should remember that the venue for any impeachment trial is the US Senate.

So, while a Democratic victory may result in the filing of Articles of Impeachment, with the Republicans in charge at the Senate, it is unlikely that any such trial would result in the removal of the US President from office.

Such a move would only contribute to legislative paralysis and drive President Trump to focus on areas where he does not require legislation to operate – primarily in the trade and immigration spheres. This would mean no easing in the pace of the agenda he has outlined to date.

From a policy perspective, if Democrats choose not to pursue impeachment, the optimists among them may seek to find areas of common ground with the Republican Senate. President Trump has already proposed middle class tax reductions and floated policy ideas hinting at major infrastructure spending. As Democrats already support an infrastructure programme, tax relief for their core Democratic voters would be likely to receive a warm welcome and the necessary legislative support.

Given the partisan atmosphere in Washington, however, the President may see his interests ahead of his 2020 re-election campaign best served by withholding cooperation with Democrats for the balance of his term in office.

On trade, hopes exist that a Democratic victory in either the House or Senate might be seen as a rebuke to the US President prompting him to retreat from his hardline on policies including trade and tariffs especially in relation to China. However, on balance, Democrats appear to support the tough stance taken against China on trade seeing it as supporting their labour and manufacturing constituents within the US. As a result, we view the election outcome as being unlikely to influence favourably the trajectory of US trade policy from the perspective of the US's trading partners.

The most likely polling predictions suggest Republicans losing control of the Senate and Democrats failing in their efforts to seize the House (3% probability as per fivethirtyeight.com) is a low probability event.

While this outcome would be the more surprising both to markets and to the President, it should ultimately result in President Trump adopting a more unilateral strategy as outlined above.

In the case of a split Congress, without bi-partisan cooperation on fiscal stimulus, the likely outcome in these scenarios would be legislative paralysis and, at best, limited impacts upon markets and the economy.

However, should House Democrats pursue impeachment hearings, the partisan conflict that probably ensues may confirm the perception of US political dysfunction that has to date not yet been reflected in either currency or bond markets.

Republicans retain control of the US Congress

An election result in which Republicans retained control of both houses of the U.S. Congress (14% probability as per fivethirtyeight.com) will probably be viewed by the White House as confirmation of support for the Trump agenda to date and will embolden the US President not only to continue along the current trajectory but potentially to accelerate and deepen the initiatives pursued to date.

Constructively, such an outcome would result in the very real potential for additional fiscal stimulus to support the US economy as President Trump prepares for his re-election campaign in 2020. A middle class tax cut combined with making those tax cuts passed in 2017 permanent are predictable policies for a Republican-held Congress. Moreover, reviving the infrastructure proposal floated during his campaign could be viewed as a way to generate blue-collar jobs heading into the 2020 Presidential elections.

On trade, continued Republican control of the US legislative and executive branches raises the prospect that the already challenging trade landscape may worsen with further tariff and potentially non-tariff pressure on China. Moreover, with the summer détente between the US and Europe on auto tariffs having yielded only a few agreements on broader tariff reductions, an emboldened President Trump may bring auto tariffs back onto the table in 2019.

Should fiscal stimulus be on the agenda in such a scenario, markets would actively have to re-price existing expectations about Federal Reserve rate hikes during 2019. As outlined in our October spotlight, *Global Equities: P/E De-Rating in Progress*, we believe the market can absorb a move to 3.5% on US 10-year Treasury yields. Should the growth and inflation picture shift to push yields still higher, interest rates would become a more significant headwind to equity returns in the new year. However, with additional stimulus underpinning economic growth, corporate earnings may be sufficient to offset P/E declines should they emerge.

Democrats seize control of the US Congress

Should Democrats seize control of both the US House of Representatives and the Senate (13% probability as per fivethirtyeight.com), the prospect of impeachment of President Trump will rise meaningfully.

However, even with majority control of both houses of Congress, removal of the sitting US president would be unlikely as a 2/3 majority of the 100 seat Senate is required for removal. With 50 current Republican Senators seated and only eight up for re-election, Democrats would require the defection of a substantial number of Republican Senators to bring about the President's removal.

If Democrats swerve away from impeachment proceedings, a very small window may exist for some cooperation between a potential Democratic Congress and the

Republican President. However, like former President Obama, who faced a Republican-controlled Congress in his second term in office, a more likely outcome will be limited legislative activity in the US Congress.

Instead, President Trump, like his predecessor would probably turn to unilateral efforts to build his 2020 campaign platform. As the legislative avenue would be closed off to him, the President could turn his attention instead to focus on trade and immigration so laying the groundwork for 2020.

Though the immediate legislative impact may only be small (as President Trump could well veto legislation coming from a Democrat-controlled Congress), any impeachment hearings may confirm the perception of US political dysfunction that has to date not been reflected in either currency or bond markets.

Moreover, should markets view the Congressional election outcome as a preview of a potential 2020 Presidential election result, equity markets may become concerned that any benefits of the 2017 U.S. tax cuts might be reversed, pressuring the historically high profitability of US corporates and bringing uncertainty and volatility to equity markets looking forward.

Growing asymmetric risks = Capital Protection + Hedge Funds

On balance, though the outcome of the November Congressional elections is unlikely to change the trajectory of many of the contentious policies of the Trump administration; only the prospect of a Republican-controlled Congress (14% probability as per fivethirtyeight.com) raises the potential for an upside surprise to the economy and equity markets.

Split or Democratic control of the US Congress (83% combined probability as per fivethirtyeight.com) in contrast creates asymmetric risks for investors and could well lead to a rollback of 2017 tax cuts and/or the potential to price in meaningful political dysfunction in the US.

Though these risks are incremental to other risks overhanging global markets, in combination, they highlight the need for asymmetric exposure in particular to equity markets looking forward. As a result, we continue to opportunistically seek capital-protected strategies and have added further to our hedge fund exposures in portfolios to manage the emergence of these risks while recognising the current strength of the global economy and corporate earnings.

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