Market Insights
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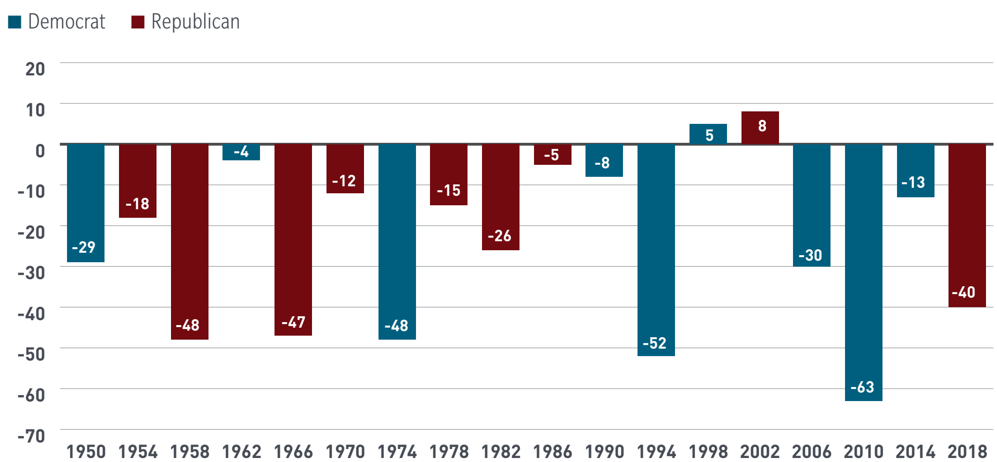
Midterm U.S. election preview: Gridlock ahead?

Investment Solutions Group

Now that Labor Day is behind us, the focus is increasing on the upcoming US congressional elections on November 8. Since 1950, the incumbent president's party has lost an average of 25 seats in the House of Representatives in nonpresidential election years. Only twice since 1950, as shown in Exhibit 1, has the incumbent's party gained seats in the House, and those were under unusual circumstances. In 1998, a backlash against the impeachment of President Bill Clinton saw the Democrats pick up seats, and President George W. Bush's Republicans gained seats in 2002 in the wake of the 9/11 terrorist attacks.

Historically, the president's approval rating plays a role in the midterm outcome, which may not be good news for President Joe Biden, whose job approval rating is around 42% in the Real Clear Politics average of polls. Additionally, four-decade-high inflation and a weakening economy are formidable political headwinds for the party in power. Research from Goldman Sachs shows that since 1950, the rate of change in US real disposable incomes has been the most salient issue in midterm elections, edging out issues such as the unemployment rate, inflation, gas prices and asset values. This is a challenge for Democrats since the latest data show US real disposable personal income has fallen 5.5% over the past year.

Exhibit 1: Net change in House seats in midterm elections since 1950



Source: The Presidency Project at UC Santa Barbara.

With Democrats holding only a five-seat majority in the lower chamber, the assumption is that Republicans will gain control of the House. But the outlook for Republicans in the Senate is less clear. The president's party has added to its tally in only five of the 18 midterm elections since 1950, most recently in 2018, a year in which Republicans lost 41 seats in the House but gained two in the Senate. However, betting markets currently give Democrats the edge in retaining control of the Senate.

What is at stake?

In order for a bill to become law, both houses of Congress must approve the legislation before it is signed by the president. If Republicans control one or both houses, it will be much more difficult, if not impossible, for Biden to pass additional sweeping pieces of legislation such as the $1.9 trillion American Rescue Plan and the $740 billion Inflation Reduction Act, both of which were enacted under arcane Senate rules which allow certain fiscal measures to pass with a bare majority rather than the usual 60-vote supermajority.

This suggests Biden will need to moderate his legislative agenda to woo Republicans or face the potential of legislative gridlock. Under a divided Congress scenario, "must pass" bills such as debt limit extensions could again involve high stakes poker games as Republican lawmakers try to exact policy concessions from Democrats in exchange for having to take unpopular votes.

Mindful of the historical backdrop of significant losses for incumbent presidents' parties in first midterms, Democrats frontloaded their legislative agenda and passed a number of pieces of ambitious legislation, perhaps setting the stage for a legislatively anticlimactic second half of the term.

Republicans would slow Biden's roll

In our view, if Republicans gain control of the Senate, further significant increases in spending and hikes in taxes are unlikely. We would expect President Biden's executive branch appointees to be more politically moderate than if Democrats were to retain control.

If the economy falls into recession in 2023, any stimulus measures meant to cushion its impact on American families will likely be modest, especially by recent standards. Given the unintended consequences of pandemic-era stimulus, such as inflation, Republicans are unlikely to prime the economic pump aggressively. Instead, incentives for businesses would probably be a Republican priority in a downturn.

If they gain control of the House, Republicans are likely to ramp up legislative oversight of the executive branch, with a particular focus on the chaotic US military pullout from Afghanistan, the origins of the COVID-19 pandemic and immigration policy.

One concern of divided government is the risk of brinkmanship, using must-pass legislation such as budget resolutions as leverage. This can result in impasses that lead to government shutdowns as funding is exhausted before legislation authorizing new spending is passed. Additionally, debt ceiling extensions are often points of contention between Congresses and White Houses of differing parties. For example, in 2011, a Republican-controlled Congress pressured the Obama administration into accepting spending cuts in exchange for raising the nation's debt ceiling but in the process came within days of breaching the debt cap. That action helped precipitate the first sovereign credit downgrade in US history when S&P cut its rating to AA+ from AAA, which in turn led to significant market volatility.

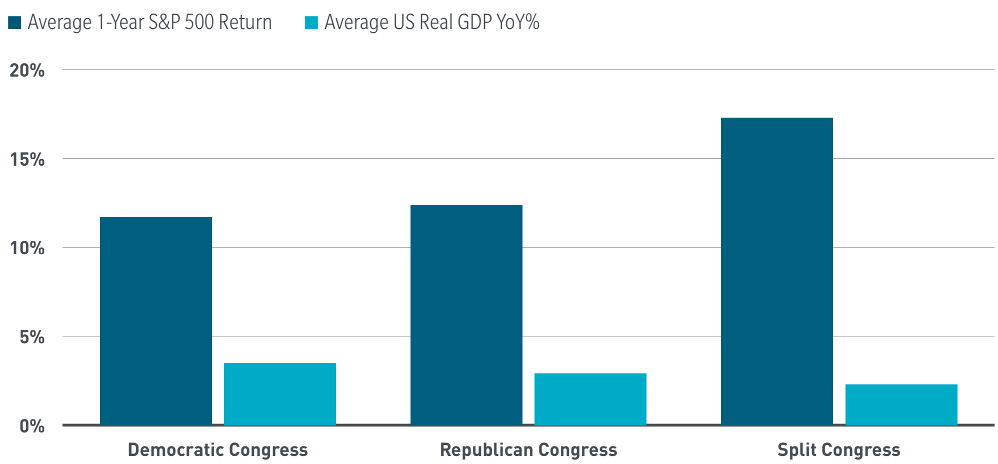
If congressional Democrats buck historical trends and retain control of both the House and the Senate, they could potentially use the budget reconciliation process to raise corporate, capital gains and individual tax rates.

Markets like gridlock

While voters might find Washington gridlock frustrating, investors historically have tended to welcome divided government. History shows some of the best periods of returns come when one party controls the White House and the other party controls at least one house of Congress.

In our view, while 2023 is likely to be a challenging investment environment, a divided Congress may offer markets a modest tailwind.

Exhibit 2: A divided Congress may be on the horizon



Source: FactSet, FactSet SPAR, History, Art & Archives: United States House of Representatives (https://history.house.gov/Institution/Presidents-Coinciding/Party-Government/). Quarterly data from 31 December 1949 to 30 September 2021 (latest available). Split Congress is defined as Senate being majority Democratic and House of Representatives being majority Republican and vice versa. Averages are calculated based on each category, using 1-year rolling S&P 500 returns and year-over-year changes in US Real GDP. S&P 500 Return is gross and in USD.

Midterm years have been the worst for markets

Historically, US market returns have been at their weakest in the second year of a presidential term. According to Ned Davis Research, the median annualized return for the S&P 500 since 1948 was 12.9% in year one of a presidency, 6.2% in year two, 16.7% in year three and 7.3% in year four. And while history shows that markets rise most years, years with midterm elections have tended to see gains backloaded until after the election has taken place, suggesting that uncertainty may be a factor in holding back gains earlier in the year. An alternative view is that presidential administrations tend to "eat their spinach" in the early days of their terms while adopting more stimulative policies in the runup to their reelection campaigns.

The bottom line is that while the horserace nature of politics is fun to handicap, markets historically have adjusted to whichever direction the political winds are blowing. As a result, we feel it's prudent not to overemphasize electoral outcomes.

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