Aegon Asset Management

MIDTERMS & THE MARKETS

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The effect on the financial markets following the upcoming midterm elections will largely be driven by the resulting changes in sentiment and subsequent changes to the business cycle. While we believe that US economic growth will slow no matter the results, macroeconomic pressure points will be affected.

What are the possible scenarios?

Republicans (GOP) hold the House (lower chamber) and Senate (upper chamber). The number of seats in the House—435—is based on the population of congressional districts. Thus, the magic number for majority in the House is 218. Currently the GOP has 235 and the Democrats have 193 (7 seats are vacant). General consensus is that the GOP loses the House as typically the incumbent party loses seats in midterms.

GOP loses the House but keeps the Senate. This is the general consensus view given the current balance of power. It also takes into consideration that historically the incumbent party loses seats in midterm elections.

GOP loses both the House and Senate. While the GOP could lose the House, losing both is unlikely. Unlike the House where all 435 members are up for re-election every two years, the 100 Senators—2 from each state—have six-year terms that are staggered so that only a third come up for re-election every two years. This year the vast majority of the Senate seats up for re-election are Democrats—and many are in states that supported Trump in the 2016 election.

What is at stake on the US political stage?

The outcome of the midterm election will influence the next two years of Trump's presidency. If the GOP holds both Chambers, there is the possibility of continuing Trump's legislative agenda, including de-regulation, trade, tax cut 2.0 bill, immigration and healthcare, among other initiatives.

If the Democrats take the House, look for a vociferous stalemate. For example, the House could produce bills for tax increases, but such bills are unlikely to make it past the Senate, and, if by rare chance they do, they would be vetoed by Trump. Separately, given the ideological divide, look for the Democrats to ramp up the attacks on Trump, taking aim at his credibility and legitimacy—e.g., the Russia investigations.

In the unlikely event that democrats capture both the house and the senate, these attacks would be even more intense – especially since few policy moves would be accomplished in that scenario save perhaps for bipartisan areas of concern such as drug prices.

If the GOP holds the Senate, the stage is set for a heated atmosphere should Justice Ruth Bader Ginsberg leave the Supreme Court. Ginsberg is 85 and her seat would be a great loss to the liberal wing. The recent events surrounding the confirmation hearings of Justice Kavanagh may be a sign of things to come.

What could be the effect on the US economy and global trade relations?

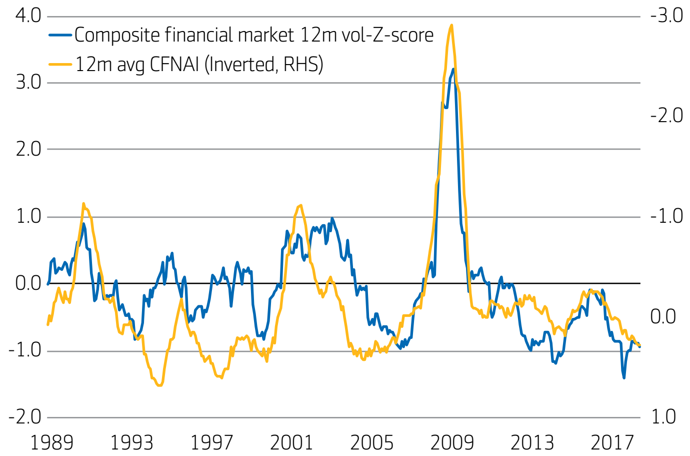
If the consensus scenario plays out with Democrats winning the House and the GOP holding the Senate, it is likely that Trump's trade rhetoric will continue. The reason is, unlike legislation that needs majority passage in both chambers, trade policy can be conducted unilaterally by the president, to a degree. Trump could cite national security concerns and intellectual property violations as reasons to sidestep boundaries set in place by the World Trade Organization (WTO). A split Congress would likely ensure little gets done policy-wise, thus allowing Trump to continue fulfilling his campaign promises on trade.

Regardless of who wins the House, we see the US economy slowing as the substantive tax cuts passed into law in 2017 begin to hit the one-year mark, setting the bar higher for future growth comparisons.

What could be the effect on financial markets?

As it stands, we expect US economic growth to peak this year and begin a march lower toward trend growth starting in 2019, as the effects of fiscal stimulus fade and we inch closer to the end of the business cycle. As is typically the case in such a scenario, volatility could rise in financial markets, especially for assets on the lower end of the risk spectrum (Exhibit 1).

Exhibit 1: Financial market volatility and macro activity



Source: Chicago Federal reserve Bank, Aegon AM US Macro Strategy, Bloomberg.

Post midterms, the effect on the financial markets will largely be driven by the resulting changes in sentiment and the business cycle. In the most likely case of a split chamber resulting in more trade rhetoric from Trump, this would heighten uncertainty. This typically results in increased market volatility, requiring higher risk premiums.

That being said, one should not ignore the behemoth actor in this debate—the Federal Reserve. We believe that the current implied path of the federal funds rate as noted by the FOMC's 'dot plot' could constitute a policy mistake and potentially end the current expansion.

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