

## US Midterms: Status Quo Is The Biggest Market Risk

By Tim Cooper

Heading into Tuesday's midterm elections ([MNI's Politics Team's full preview is here](#)), the broad expectation is that the Republicans win at least one if not both chambers of Congress.

From an asset class perspective, the impact of that is likely to be muted: there is 85-90% chance implied by bookmakers of Democrats losing full control with Republicans gaining one or both houses. Furthermore, there is little discernable pattern in post-midterm asset moves: equities tend to rise in the aftermath of midterms no matter the result (though that is their natural long-term direction anyway); USD and Tsy returns are more mixed.

### Election Scenario Matrix

Chart 1: Percentage Chances of Each Party Winning Chambers of Congress

	Republican	Democrat	
House and Senate	40%	10%	House and Senate
Just Senate	15%	35%	Just Senate
Just House	35%	15%	Just House
None	10%	40%	None

Source: MNI

In this regard though, the more interesting take from a risk-reward perspective is for a strong bearish Treasuries, bullish dollar move in the event the Democrats do the unlikely and win both the Senate and the House. That may seem counterintuitive given that it would simply reinforce the status quo. But a strong reaction would be expected because it would change the macro policy setup for 2023 in a more expansionary fiscal / tighter monetary direction than is overwhelmingly priced in.

Looking purely at midterm elections (ie when the White House is not at stake), the last 7 (since 1994) have seen the following returns (see table). Equities are the only asset class that really stand out directionally: to the upside. Otherwise there is basically no discernible pattern in dollar and Treasury performance - it depends on the circumstances, macroeconomic and otherwise.

Table 1: Post-Midterm Election Returns (changes calculated from Oct 31 of midterm year)

12M	2018	2014	2010	2006	2002	1998	1994	Avg	Max	Min
SPX %	12.4	3.0	8.9	11.1	18.2	17.1	23.5	13.5	23.5	3.0
DXY %	0.5	11.5	-7.5	-10.0	-13.5	3.0	-2.2	-2.6	11.5	-13.5
10Y UST yield (ppt)	-1.37	-0.19	-0.48	-0.22	0.45	1.31	-1.77	-0.33	1.31	-1.77
6M	2018	2014	2010	2006	2002	1998	1994	Avg	Max	Min
SPX %	8.6	3.3	15.5	7.6	3.5	14.7	9.0	8.9	15.5	3.3
DXY %	0.4	8.8	-10.2	-4.5	-8.9	5.0	-4.5	-2.0	8.8	-10.2
10Y UST yield (ppt)	-0.64	-0.30	0.49	0.02	-0.06	0.63	-0.75	-0.09	0.63	-0.75
3M	2018	2014	2010	2006	2002	1998	1994	Avg	Max	Min
SPX %	-0.3	-1.1	8.9	4.4	-3.4	10.0	-0.4	2.6	10.0	-3.4
DXY %	-1.6	9.1	-4.3	-0.8	-6.3	-0.1	2.7	-0.2	9.1	-6.3
10Y UST yield (ppt)	-0.51	-0.69	0.57	0.21	0.07	-0.06	-0.23	-0.09	0.57	-0.69

- **The near-term move (3M)** has tended to be a weaker dollar, while equities and yields have been mixed (notably the last two midterms have seen a fairly sharp drop in yields though mixed USD).
- **6M out**, equities are clearly moving higher, with the dollar tending to be a little lower and yields slightly mixed (though note again the last two times the DXY has been stronger in the 6-months post elections).
- **A year later**, equities are the clear winner. Yields have tended to fall more often than not, while USD performance is, again, very mixed.

Looking at the last 3 elections (including presidential election years), each has lessons for 2022:

- In the 2016 elections when Trump beat Clinton against most expectations, the immediate knee-jerk reaction was "sell everything" with equities and Treasuries, and USD sinking. But this looked more of a reactionary move to a badly mispriced outcome (going into election day, Clinton was priced 80-90% to win by bookmakers, similar to the percentage attributed to 2022's core outlook). Ultimately equities and the USD resumed their longer-term uptrends with Treasuries continuing lower as multiple pro-cyclical macro possibilities emerged, including tax cuts.
- In 2020, while the eventual outcome (Democrat sweep) was mostly priced in (60-65% odds), we had to wait until January 2021 for Senate control to be determined by Georgia runoffs - that might occur again this time. The market reaction wasn't complete until months after the election, when the expansionary fiscal implications could be priced. Stocks ascended with USD falling and Tsys drifting lower after the November elections; however starting in January, the USD bottomed out and Tsys began to plunge (equities continued to rise).
- But the best recent analogy for the 2022 election setup is the last midterms in 2018: an incumbent president's party faced a loss of Congressional control (the Democrats were seen with an 80-90% chance of winning control of the House with Republicans a similar % of retaining the Senate). That's what played out, and there was little market reaction. However, economic and market headwinds emerged in the year following, which among other things saw the Fed end and reverse its hiking cycle.

Under the consensus outcome for 2022, 2018's results could echo this time around, with the Fed tightening into an economic downturn/recession expected by many by late 2023.

- **The consensus outcome of Democratic losses in 2022 will, on margin, do little to derail the dollar's rise.** And unlike historically in midterms, where policy is in limbo, the White House might rely heavily on executive orders as opposed to legislation. For example, Biden could take an increasingly populist tack going into his re-election year in 2024, particularly on trade – which would further undermine some foreign currencies' appeal.
- **Equities will probably benefit, but it's not straightforward.** Divided government result as it tends to reduce equity market uncertainty. But today is a little different since the White House is likely to exercise executive orders more extensively than the historic post-midterm equity record might suggest.
- **The baseline for Treasuries is somewhat more mixed:** there wouldn't be much change in the macro configuration. But the debt limit will become a hugely contentious issue under a Republican Congress, and some brinkmanship is to be expected in 2023. That's probably priced, but the ultimate impact on Tsys is hard to gauge: we'd be more inclined to expect a "safe haven" move if the debt issue comes to the brink, though have seen arguments that such a bid might not materialize this time.

## Fiscal And Monetary Policy Responses

One question following the expected result in the midterms - how does policy respond to an economic downturn?

- **The odds of getting an economic stimulus package to ward off a recession are more remote with a split Dem/Rep government.**
- If the Fed were to be seen as being obliged to do the heavy lifting on policy easing where fiscal authorities fail to deliver counter-cyclical stimulus, it would be beneficial for rates and possibly negative for the dollar. But this time, the Fed is combatting a major inflation problem, and is unlikely to ease without significant evidence that inflation is coming down.
- Lack of both fiscal and monetary stimulus could imply bigger-than-usual downside economic risks. So if a slowdown does materialize, we could see a much flatter yield curve and a stronger dollar, with equities dropping further.

A Democrat sweep (only 10% probability) is the most negative scenario for Tsys and the most bullish for the USD.

- Not only is this outcome completely unexpected, fiscal stimulus going into 2023-24 would begin to look much more likely, particularly if the Democrats gain rather than lose seats – in an echo of January 2021 when their Senate win became known.
- This outcome would probably allow/force the Fed to signal further tightening than currently expected. Even if the Fed is eventually given room to ease alongside stronger fiscal stimulus, long before that happens, signals of fiscal expansion would be likely to further bias Fed policy to the tight side.