

Beyond the US Midterm Elections

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Aneeka Gupta

Director, Macroeconomic Research, WisdomTree Europe

The big surprise from one of the most expensive and engaged midterm elections in US history was that for the first time since Brexit and Trump's triumph in 2016 US elections, the polling survey and consensus actually got it right! This begs the question, if most of the information was priced in, why did the US equity markets rally after obtaining the official midterm results? We believe the reasons are three-fold.

Spending on Midterm elections surpassed the \$5Bn mark for the first time

Source: Centre for Responsible Politics, WisdomTree, data available as of close 14 November 2018.

Markets breathe a sigh of relief

1. Firstly, while history can't be used as a precursor for anticipating the future, it's worth noting that in the 12-months following each US midterm election since 1946, the US equity markets have posted a positive performance.
2. We also believe a wave of uncertainty was removed after the official results were declared which also lent buoyancy to the US equity market rally. Evident from these two reasons, sentiment started to improve.
3. Finally, the details of the results highlighted that it wasn't a clear sweep of blue for the Democrats. While the Democrats took control of the House of Representatives, the Republican party increased their majority in the Senate.

Implications of gridlock

Two things we can draw from this election result:

4. We are unlikely to see the unwinding of the first round of tax cuts.
5. We are unlikely to see the re-regulation of the US economy.

As additional fiscal expansion is less likely to be on the cards, the probability of Tax reform 2.0 is lowered. The gridlock in Washington also narrows the risks that labour costs and bond yields rise rapidly from here. This is likely to benefit global markets as the Fed's rate trajectory will be more gradual as the fiscal boost from last year's tax cuts fade in 2019.

Interestingly if we strip out the tax effect from the latest Q3 US earnings results, average earnings growth expectations in the US would decline from 26.7% to 18% and when compared to the rest of the world at 10%, still places the US on a strong footing.

We do expect to see more congressional oversight on what Trump does next. And despite the rise of investigative committees, Trump is likely to avoid getting impeached as the Democrats would be extremely unlikely to get the 67 Senate votes necessary to remove him from office. While there is a strong likelihood on bipartisan support for an infrastructure plan, we expect the split congress could have more disagreements over its implementation and funding.

Debt ceiling risk is underappreciated

The funding for the US federal government is due to expire on 7 December 2018, presenting the likelihood of a government shutdown that could last until year end. President Trump's proposed wall on the border with Mexico and special counsel Robert Mueller's investigation are likely to extend the deadlock. We also believe markets are under-pricing the upcoming debt ceiling which should come to the fore in March 2019. While September/October 2019 will be a more critical time for a hard-ceiling. Democrats are likely to use the impending debt ceiling as negotiating leverage to address the need to raise corporate taxes, increase personal income tax rates for the highest bracket and lay a greater emphasis on green initiatives (renewable energy and electric mobility) in the infrastructure spending plan.

Polarized congress could slow trade policy

We are already starting to see reverberations of the new political landscape being felt in trade policy. Just 7 days after the midterm results, comments by a key democratic representative Bill Pascrell, who is positioned to chair the Ways and Means Trade subcommittee suggest the ratification of the recently struck United States-Mexico-Canada deal, known as USMCA, that was supposed to take place at the end of November, will have to wait well into 2019. Consideration of the USMCA will provide signals of issues of concern to Democrats that could have implications on other agreements. The US Trade Representative (USTR) notified Congress on October 16 of its intention to begin negotiations for trade agreements with Japan, the European Union (EU), and the UK. The uncertainty around US trade policy remains the biggest hurdle for the global economy. Some of the world's biggest exporters such as Japan, Europe and Emerging markets are starting to see the spill over effects. While we expect to see greater oversight from the Democrats in regard to trade policy, the USTR aims to provide a quick turnaround on less controversial issues. In the case of EU, enlarged quota for high-quality beef and sales of US soybeans will dominate negotiations, while market access for autos and agriculture will be the main focus with Japan. US farmers are facing their worst economic year in a long time and this could push the members of congress to adopt a more moderate stance. China trade policy is most likely to be an important element of both parties' presidential election campaigns for 2020, so an important emphasis will be laid on the administration's approach to China.

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