# 12 / The midterm results are in, and it's a gridlock -- what does it mean for the financial markets?

The U.S. midterm elections played out much as expected, with Democrats picked more than enough seats needed to retake the majority in the House of Representatives and Republicans easily defending their majority in the Senate. **We have gridlock, but that may not necessarily be seen as a negative outcome by the markets**. The US economy, though currently decelerating, should do all right next year with government control divided between Democrats and Republicans. Divided governments have generally been decent for markets. **The basic reason for this is simple**: when one party proposes drastic or foolish measures, the other party can obstruct them. The United States prospers most when excesses are curbed, and, if the numbers from the past 50 years are any indication, divided government is what curbs them (*passages taken from the writings of the late economist William A. Niskanen*).

**Now that the Democrats control Congress, will they try to impeach President Trump?**

**The Democrats will almost certainly challenge and try to distract the president over his past and current business dealings, tax returns** and the Constitution's Emoluments Clause (which prohibits US officials from personally benefitting from office). However, though the House may have enough votes to impeach, the Senate is very unlikely to convict. That would create a scenario similar to that of President Bill Clinton's in 1998. In other words, any concerns that Trump will not remain in office until his term expires is highly unfounded.

**Some key take-aways from the midterm election results:**

**There will be greater difficulty for many aspects of President Trump's agenda, but we do not see the midterms as hobbling Trump as a lame duck by any means.** While Democratic control of the House implies greater political and perhaps legal difficulties for Trump, the election result came short of a so-called "blue wave" that would have rejected the president wholeheartedly, as the Republicans gained ground in the Senate. Because of these factors and the fact that Trump is far from a lame duck, we expect him to continue to pursue his platform vigorously.

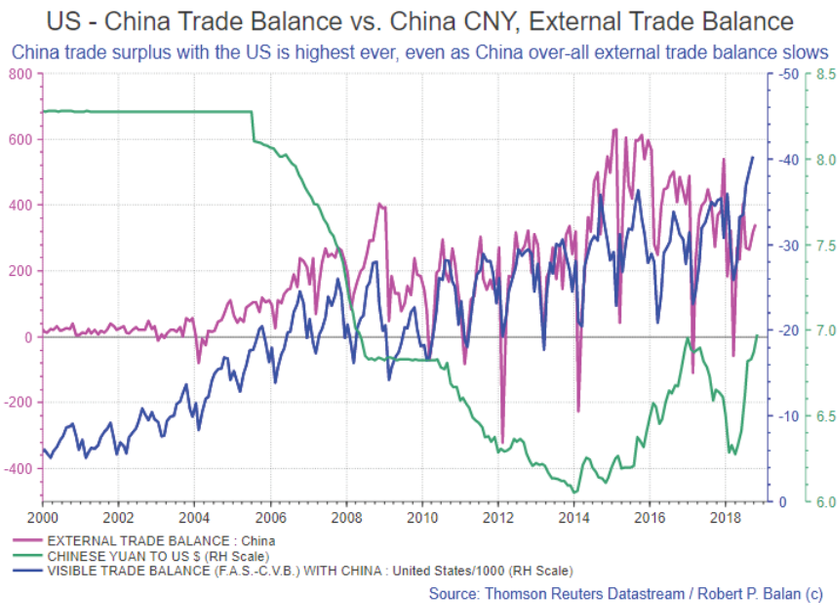
**The US Senate remains solidly Republican - more so than before the midterms. A GOP-dominated Senate makes it easier for Trump to confirm appointees.** Expect a Cabinet shuffle to take place soon, (Sessions was already the first Cabinet official to go), and a more Republican-leaning judiciary. The Senate is virtually the "personnel department" of the US government, as it is responsible for confirming all high-level appointments by the president. The new Senate will be able to continue confirming Trump nominees -- and the process going forward will likely be less of a nail-biter and contentious than the recent confirmation of Supreme Court Justice Brett Kavanaugh. We expect presidential nominees should be more easily confirmed during the second half of Trump's administration.

**Because the Republican Senate majority is bigger, efforts toward deregulation should continue**. At a minimum, a reversal of deregulation is unlikely, in our view. We believe these factors should still support business optimism and support growth.

**Immigration is an area that has become ripe for compromise, and maybe the odds for a comprehensive immigration bill have become better after the elections**. Post-election, immigration has ceased to be a political rapier. Nobody thinks the current law is ideal, and nobody thinks current law is being enforced. Both parties have made points and marks with this issue – maybe it is time for some rationality to become part of the discussions.

**Will the trade skirmish with China continue?**

**Expect trade policy risk to persist**: trade is one of the levers for which the president does not need Congress, so we could see a doubling-down on trade policies. Moreover, both Democrats and Republicans are believed to support a tougher stance on Chinese trade and intellectual property practices. As a result, the president may enjoy bipartisan support as he pushes for Beijing to reduce the bilateral deficit. There is less middle ground for practical trade policies than has been the case historically. Partisan Democrats traditionally have been the



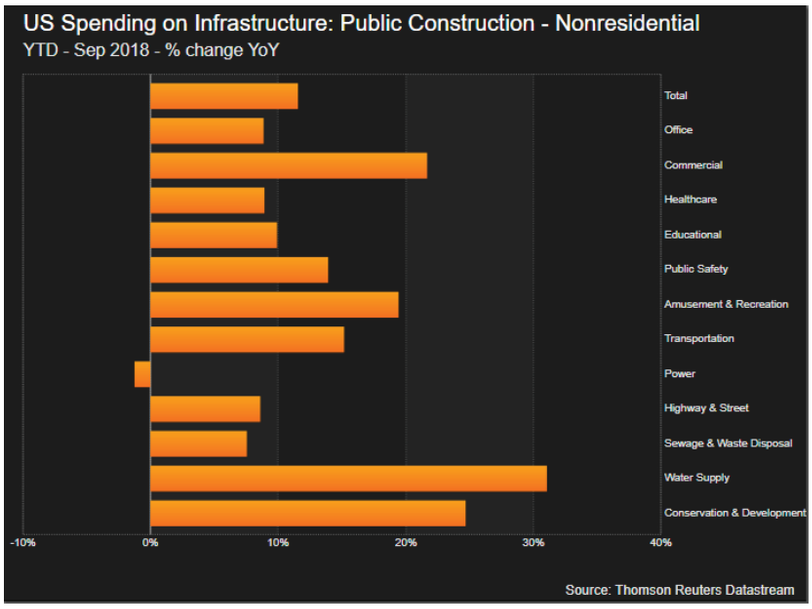
more protectionist party while Trump Republicans are extremely hawkish with regard to everything relating to China. There is convergence of interests of both parties with regards to confronting China on trade issues, especially at a time that China's surplus trade balance versus the US is at an all-time high (*see chart on previous page*).

**However, expect a scuffle over NAFTA 2.0 (the United States-Mexico-Canada Agreement, or USMCA)**, as Democrats will want to leave their imprint, which could also mean the president may again threaten withdrawal, going to the brink once more. But we expect NAFTA 2.0 to pass eventually because many state economies are highly integrated with both Canada and Mexico, and a failure would affect major constituencies on both political parties.

**Huge upside for infrastructure spending**

**There is a huge upside for infrastructure during Trump's second half tenure**. Democrats want to show they can govern and will likely focus on areas of agreement, including infrastructure, criminal justice reform and drug pricing. Democrats have always said they support infrastructure projects. There are now fewer deficit hawks among Senate Republicans (some of them lost in the election) to oppose infrastructure spending.

**We believe that if the works are targeted to specific regions and projects, there would be convergence between Trump and the Democrats on infrastructure spending**. There is a real possibility that the Trump administration may reach across the aisle and strike a deal with House Democrats for a significant infrastructure spending package. Highways & Streets, sewerage and power infrastructures have been neglected in the US, and have been low priority recipeints of government funding in recent years (*see 1st chart on this page*). **That could provide significant support to raw materials prices and the stock of materials producers.**




**Chances for an infrastructure deal will depend on how Democrats propose to pay for it**: If it includes rolling back tax cuts, it would be dead-on-arrival in the Senate. If infrastructure spending can be financed through some other ways, a deal will have very good chances of passing.

**Investment implications in the election's aftermath**

**Both the president and Democrats seem to agree on greater regulation and taxation of technology companies**, so further underperformance in the tech sector, which has been richly valued relative to other sectors, is a distinct possibility, during the next two years.

**The president and Democrats also agree on regulation of drug pricing**. However, any sell-off or underperformance in pharma and biotech stocks due to imposition of new regulations, should be temporary. Senate Republicans are very unlikely to agree to any bill that would regulate drug pricing.

**Democratic control of the House almost guarantees that there will be no repeal of the Affordable Care Act** (aka, Obamacare), which should ensure more clarity and stability in regulation and pricing for insurers and hospitals and the health care sector overall.

**Both Mr. Trump and the Democrats have advocated an increase in the federal minimum wage**. While we think it would be difficult to get through the Senate, if it were to pass, it would create pressure on US retailers and restaurants. Several states have already increased minimum wages, as have some major employers like Amazon. Therefore, the effects are more likely to be firm-specific than general, and will be temporary.

**Looking forward to 2019 and 2020, expect less extravagant federal spending growth** – except possibly for infrastructure spending. Major tax cuts are unlikely. But deregulation should continue in those areas where Congressional approval is not needed. This direction will be good for the US economy.

**Mr. Trump and the US Dollar**

President has famously said at the outset of his tenure that he wants lower exchange rate values for the US Dollar, in line with his desire at that time to encourage US exports. This desire was of course thwarted by the Federal Reserve's policy tightening regime, which boosted interest rates and consequently the US Dollar's exchange rate valuation. Trump's desire for a cheaper USD was also sunk by his tax rate cuts for corporates and the US middle class. Foreign capital flooded in, and domestic capital repatriation improved the US capital account tremendously. Capital account

inflows morph into Foreign Direct Investments (FDIs) after a short lag, and US FDIs correspondingly promote stronger US Dollars. (*see 1st chart on this page*)

The US Dollar looks set to strengthen until late 2019, so there are strong headwinds for Trump's desire for a weaker domestic currency. There is a silver lining to all this -- a strong currency which has the potential to become even stronger, tends to attract significant amounts of FDIs. Therefore, The Donald may yet be successful in his desire to attract manufacturing companies to settle in the US. A strong US Dollar, which promises to become even stronger, should be the wherewithal for that to happen.

**Conclusion**

The prevailing view is that gridlock is a positive from the US political side for financial assets, and the potential lack of disruptive initiatives should enable macroeconomics to play out in full. And the macro conditions which are still currently wobbly on the short term should prove a bit more favorable from mid to late Q1 as current, capital inflows provide wherewithal for continued support for growth and rebound of risk assets. (*see 2nd chart on this page*)

If Trump and the Democrats do broker an infrastructure spending deal in 2019, we believe there is still time to bet on the outperformance of risk assets more broadly, and focus on attractive beta-producing momentum opportunities. **Commodities and commodity producers (including oil companies) should perform well under this environment** (*see 3rd chart on this page*).

**The combination of factors summed up above suggests that after the current soft patch, the US economy should continue to grow from mid/ late Q1 2019, but may well decelerate in 2020 as the benefits of the distributed lagged capital inflows and fiscal stimulus moderate in the face of rising Fed policy rates.** Moreover, deficit spending should slow, as the Democrats will try to push back against Trump initiatives that could enhance his reelection. However, there is silver lining provided by this situation as it lowers the chances of a boom/ bust scenario further down the line (by reducing the risk of another fiscal stimulus that could boost inflation, which is already at the Fed's target, by lowering unemployment further and requiring the Fed to move faster).