

US midterms fulfil market expectations

Constrained Trump erraticism portends improved US-China relations

by Elliot Hentov in London

Fri 9 Nov 2018

In his first electoral test since 2016, US President Donald Trump appears to be more beholden to historical norms that he might like to admit. The performance of his Republican party in the 6 November midterm elections remained in line with past trends, suggesting that traditional polling continues to be useful in predicting US political outcomes. With a strong economy and a relatively unpopular president, the US electorate re-established its historical baseline, namely divided government.

Initial market reaction has been positive, as the outcome fulfilled expectations. While the chance of gridlock in Congress is higher, the result also reduces the probability of negative policy surprises. This increases the importance of macroeconomic fundamentals as a driver of equity performance. Since 1946, the S&P 500 has delivered positive returns in every 12-month period following a midterm election. Moreover, the fourth quarter of a midterm year typically generates the highest return of that year. While the past is not always a guide to the future, given the October drawdown and a stable election outcome, there is a strong likelihood of markets adhering to a similar pattern.

The outcome suggests that despite shifting the priorities of the Republican party and deploying unconventional tactics, Trump remains bound to historical norms around US voter preferences for shared power. That is the central insight from this result: the loss of total Republican control of Congress should constrain Trump's erratic behaviour.

The Democratic takeover of the House of Representatives could exacerbate legislative gridlock and intensify Congressional oversight of the Trump administration. There are numerous allegations of impropriety, possibly criminal activity, among cabinet officials. A stream of investigations into these allegations could distract or weaken the president's agenda. Not least, the Mueller investigation will be permitted to unfold, possibly exposing individual vulnerabilities. Under such circumstances, Trump's room for manoeuvre should shrink, though it is important to note that aside from tax reform this has been a quiet legislative period.

The midterm outcome does not affect the likelihood of Trump's re-election. That said, his 2016 victory relied on a narrow majority in swing states. Three of the four most critical states – Pennsylvania, Michigan and Wisconsin – elected Democratic senators and governors in the midterms. Only Florida remained Republican, but by the narrowest margin. In 2020, turnout among Democrats is likely to be at least equal if not higher than on 6 November. In short, Trump may need to do more than rely on his base and a favourable economic backdrop to win in 2020.

To understand the importance of yesterday's voting, one must look beyond the House races to the Senate, governor and referenda contests. In line with polls, the Republicans were able to expand their majority in the Senate. Trump has already taken credit for securing the Senate victory, pointing out that most of his campaign rallies took place in states where Republicans ultimately won. However, this ignores the fact that these campaigns were largely in deeply red states where his approval rating hovers near or above 50%. In other words, the Senate result does not contradict the House result.

More importantly, the gubernatorial races suggest the political current has shifted away from Trump. The Democrats gained seven governorships net, restoring a more balanced distribution of 23-27 governorships across the country. This matters for the redistricting ahead of the 2020 elections and the mobilisation of local voters. In addition, several ballot measures were passed that could further boost turnout in key swing states. Florida restored voting rights to roughly 1.5m former felons, and Michigan approved gerrymandering reforms and same-day voter registration. Another noteworthy trend has been the surge in female representation in Congress, with more than 100 women expected to take their seats in the House, in addition to 20 in the Senate. At around 23%, the US now ranks 26th among the 36 Organisation for Economic Co-operation and Development countries, up from 31st, in its proportion of female parliamentarians.

The midterm result could also help improve the trade stand-off between the US and China. While trade policy is one of the few domains in which US presidents can exercise executive power, the politics of the election favours a course correction. With the arrival of several domestic challengers, Trump will refocus attention on domestic matters where he can leverage US polarisation to his benefit. In this context, any Chinese proposals that offer improvement in the US trade balance and intellectual property protection could be enough for Trump to call a ceasefire, at least until the dispute with Beijing becomes politically useful again. This could remove a major market concern over the coming year.

Elliot Hentov is Head of Policy & Research in the Official Institutions Group at State Street Global Advisors, and a Member of the OMFIF Advisory Board. This article first appeared on the [SSGA blog](#).