Market and Economic Insights

Strategy Spotlight

U.S. Midterms: Will a Blue Wave Rock the Boat?

While NAFTA may have been signed, the upcoming U.S. mid-term elections are still important to Canadians as we get into the implementation phase of the agreement. If Democrats prevail, Trump may be more willing to negotiate as potential issues arise but if Republicans win, he may take a more hardline approach.

In this report we'll look at:

- Trump's approval ratings and which way the polls are trending
- Potential election outcomes and expected implications
- U.S. growth expectations over the medium term

U.S. midterm elections typically serve as a referendum on the first two years of a president's term, often resulting in steep congressional losses for the president's party. The 2018 election appears to be following a similar pattern, with the Democrats' lead on a generic congressional ballot peaking in late 2017 when President Trump's net disapproval rating was also at its highest. However, as the economy has maintained momentum through 2018, President Trump has gained popularity while the Democrats' prospects have declined modestly.

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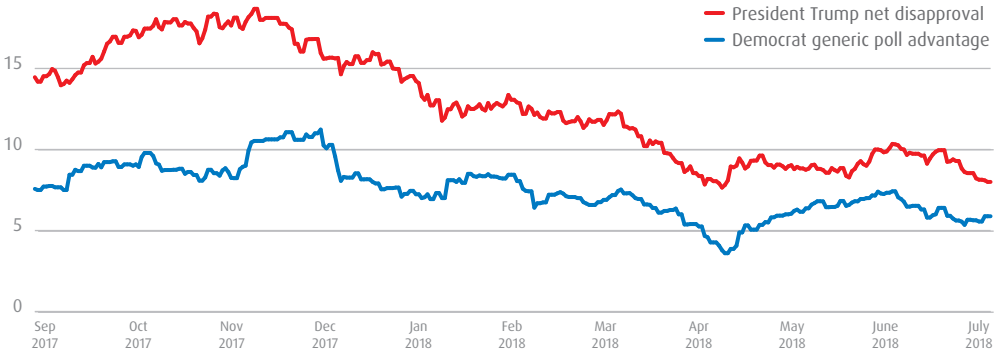
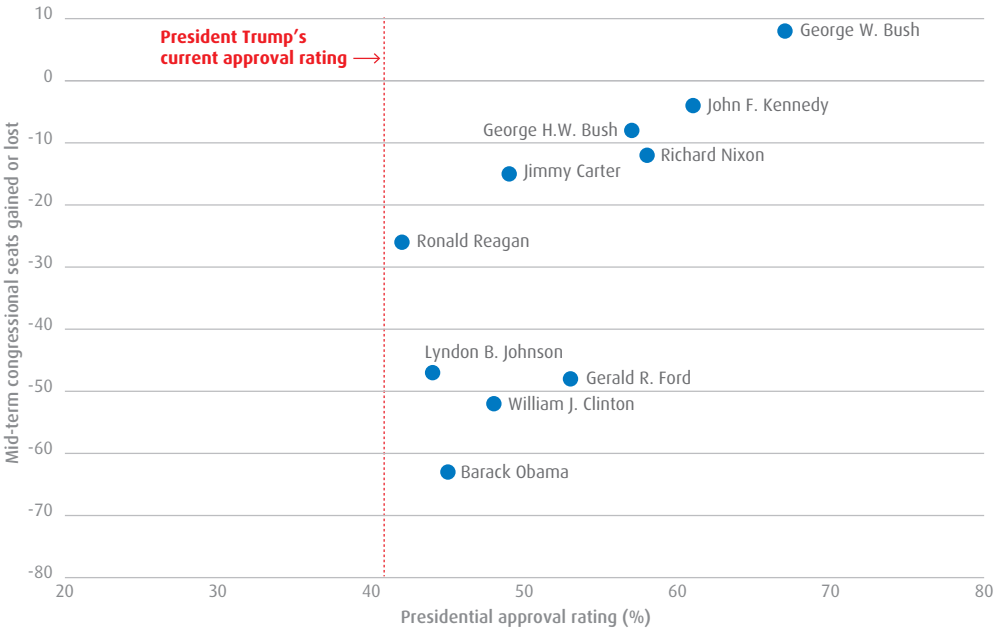
Congressional voter intentions track presidential polls



Sources: RealClearPolitics, BMO Global Asset Management

The U.S. House of Representatives tends to have significant turnover in party composition due to the short two-year terms for each member. Republicans currently hold a 43-person majority in the House but will need a strong showing in November to protect that majority. Inputting President Trump's relatively low 44% average approval rating into a simple regression analysis of first-term presidents' midterm election results (starting with John F. Kennedy) indicates Republicans are expected to lose 45 seats in the House. Considering they need to hold 43 seats, this analysis suggests House control is a toss-up. However, we think the Democrats have a better chance of taking the House due to the actual results they have posted in special elections over the trailing year, particularly in Republican-leaning districts in Pennsylvania, Kansas and Ohio. They have momentum and enthusiasm on theitr side, which should bring out their voters.

First-term presidential midterm election outcomes



Sources: UCSB The American Presidency Project, RealClearPolitics, BMO Global Asset Management

"Republicans hold a stronger advantage in the Senate, where six-year terms mean fewer seats in play during a given election year.

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Republicans hold a stronger advantage in the Senate, where six-year terms mean fewer seats in play during a given election year. The current composition is 51 Republicans and 49 Democrats (including Independents who caucus with Democrats). However, the 2018 election map favors the GOP, with 26 Democratic seats up for reelection compared to only nine for Republicans. Thus, the odds of Democrats taking the Senate — while certainly realistic — are lower than their House chances.

Election outcomes and expected implications

Outcome	Assessed likelihood	Expected market implications
Split government	High	Mostly priced in. Democrats will ramp up investigations into President Trump's actions and strive to thwart his agenda wherever possible. Likely a stalemate for two years as both parties posture into the 2020 elections.
Republican hold	Moderate	Short-term positive. Potential for further tax reform and continued deregulation. Raises probability of Democrats moving further left in 2020, which would be negative for the U.S. market over the longer term.
Democrat sweep	Moderate	Short-term negative for the U.S. market and positive for international markets. Democrats will likely push for impeachment, but the necessary two-thirds supermajority in the Senate would make this a high hurdle. Democrats would attempt to blunt some of Trump's hardline trade policies, particularly with current allies (and likely excluding China). Dollar negative as deficit spending likely to increase further.

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We do have some concerns regarding a split government, as equity returns tend to underperform during these periods. One theory is that a split government slows down the response to bubbles and crises, as was clear during 2007–2008. However, the U.S. economy is on firm footing over the medium term, so we are less concerned with the composition of the government. Our concern would increase if the economy decelerates, as a sluggish government response would provide more downside.

	S&P 500® annualized real return (%)	Percentage of instances (%)
Democratic control	7.6	27.7
Republican control	12.6	9.8
Split government	4.6	62.5

Sources: BMO Global Asset Management, House.gov, Senate.gov, Library of Congress
Note: Analysis starts in January 1961.

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Conclusion

The midterm elections have the potential to shape U.S. policy over coming years and thus we are watching them closely. In our view, we don't think the outcome of these elections could disrupt the U.S. economy's strong growth over the medium term. But given that we think the Democrats are likely to win the House, a reshuffling of power in D.C. would help reduce anxiety over trade wars, though not entirely as we suspect the #POTUS Twitter feed would remain hot. For Canada, the new trade deal with the U.S. and Mexico confirms our view that North-American trade flows will remain largely intact, although some tariffs on steel and aluminum remain in place. While we think the removal of NAFTA uncertainty is a small positive for the Canadian economic outlook and the loonie, our overall positive view on investor's risk appetite and overweight on U.S. equities remains intact. For interest rates, markets had already been discounting NAFTA risks as expectations for gradual rate hikes by the Bank of Canada are firmly anchored, and as such we continue to prefer a shorter duration within fixed income.

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