Investment Event

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Midterms result in split Congress

The midterm elections are poised to result in a split Congress, as widely expected

Further tax cuts are unlikely. Increasing the debt ceiling may re-emerge as a source of political tension

Domestic constraints could result in more activist foreign policy from the president

Debate around infrastructure plans may intensify, but there are significant political and financial limitations to action
Our views

Democrat House, Republican Senate

The US midterm elections are poised to result in a split Congress, with the Democrats taking the House of Representatives (HoR) and the Republicans holding the Senate, as widely expected. Projections suggest the Democrats are likely to win around 230 of the 435 seats in the House while the Republicans are on target for 53-54 of the 100 Senate seats, against 51 previously.

Increased tensions

We doubt that the new split Congress will have a meaningful impact on the trajectory of the US economy over the next couple of years. The bulk of the measures from the Tax Cuts and Jobs Act (TCJA) have already been implemented and President Trump may veto any attempt by the Democrats to reverse the stimulus. However, there are some potential effects worth noting:

- The result reduces the potential for further tax cuts over the next two years. A Republican majority in both houses, on the other hand, would have left open the possibility of modest tax reductions to slow the pace at which the current stimulus is expected to fade in 2019.
- The debt ceiling may re-emerge as an issue. Currently the ceiling on federal debt has been suspended until 1 March 2019. Once it is re-introduced, it will most likely need to be raised again. In 2011 and 2013, the Republicans used the Congressional vote needed to raise the ceiling as a tool to frustrate President Obama's agenda, ultimately resulting in a 16-day federal government shutdown in October 2013.The Democrats may now return the favour.

A split Congress does not change our core asset class views. We remain neutral on US equities and underweight Treasuries, although we think yields are approaching attractive levels

- There is a risk that if the split Congress means the president cannot make progress on his domestic agenda, he becomes more activist on the international stage using his executive powers, which might increase market volatility.
- Democrat control of the HoR opens the door to Congressional investigations, including subpoenas. It would also allow the Democrats to try and impeach President Trump if the investigations found evidence of wrongdoing. Again, this could raise market volatility

Infrastructure boost?

Ahead of the midterms, there was some discussion that a Democrat HoR could push hard for a USD1 trillion (5% of GDP) boost to federal infrastructure spending, given that upgrading the country's infrastructure is generally seen as a less partisan issue than most. In our view, however, there are a number of political and financial obstacles to pushing through a large-scale infrastructure programme.

It is worth remembering that President Trump's own plan, which is considerably less ambitious (a USD200 billion increase in federal funding for infrastructure) has made little progress, which suggests the Democrats would have to rein in their expectations of what is achievable.

A fundamental constraint on pushing through a large-scale infrastructure investment programme is agreeing where the money comes from. The International Monetary Fund (IMF) forecasts a US structural budget deficit at 5-6% of GDP by 2019, at least double that expected in other major developed economies. It also sees the debt/GDP ratio rising towards 120% by 2023; among G20 countries, only Japan and Italy have higher projected debt ratios.

An alternative to debt-financed spending would be to raise taxes. However, a Republican Senate or President Trump are unlikely to support significant tax increases.

Market considerations

As it was widely expected, we think a split Congress is unlikely to have a significant impact on markets in the short term. Equally, it is not clear whether it would have much impact on the economy over the next couple of years. We therefore see little by way of implications for our core investment views. Within the context of being underweight developed market government bonds, US Treasuries look more interesting to us given the yield on offer, particularly at the short end, but increasingly at the long end too, following the recent sell-off. We remain neutral on US equities, although Treasury yields are approaching levels that may represent a headwind to risk assets.

A split Congress may inject additional volatility into markets at certain points, if it leads to the threat of government shutdowns when the debt ceiling needs to be lifted or if domestic gridlock pushes President Trump into greater foreign-policy activism..

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