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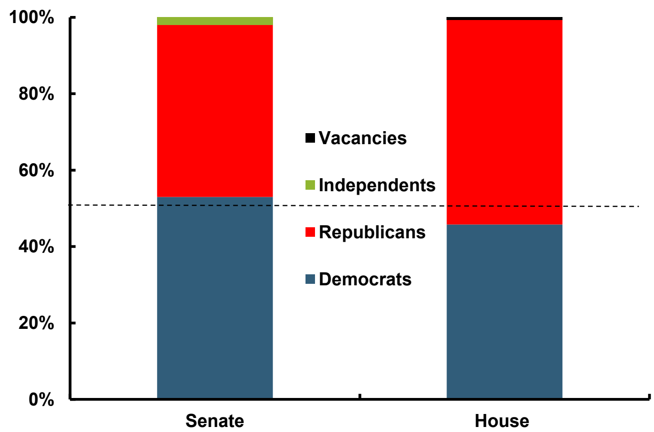
US midterm elections – are markets paying too little attention to the upcoming vote?

Key points

- US midterm elections will be held on Tuesday 4 November.
- Polls suggest Republicans should extend their majority in the House of Representatives, possibly to an 86-year high.
- The Senate race is close, but on balance polls suggest Republicans could overturn the slim Democrat majority.
- Markets have been relatively unconcerned ahead of these elections, despite the prospect of a Republican Congress becoming even more intransigent with the White House.
- We believe this primarily reflects hopes of fading belligerence in US politics – at least for the coming session.
- A period of grudging cooperation would have a positive impact on the US economy, particularly in relation to upcoming fiscal decisions and international trade deals.
- Even if such cooperation may simply be part of longer-term positioning ahead of the 2016 Presidential Elections.

Exhibit 1
The current breakdown of US Congress



Source: Congressional Research Service and AXA IM Research

US midterm elections are held on Tuesday 4 November. While the race for Congress is starting to get increased media coverage, it appears to be having little impact on market thinking. In part, this reflects an expectation that the political landscape will not change greatly whether the Republican party gains the Senate in this election – which current polls suggest looks likely – or not. We have sympathy with this view. We expect the final two years of President Obama's Presidency to remain in relative political stalemate, leaving important longer-term policy decisions, including fiscal planning, on ice. Indeed, with an eye to the Presidency in 2016, a Republican Congress could be even more intransigent in any bills submitted to the White House. However, we believe Congress could also be less belligerent. Accordingly, markets appear prepared to look through November's elections. However, we note that these midterms could still result in a shifting policy bias that could prove equity market supportive.

The elections

With President Obama not up for re-election, the midterms contest seats in the House of Representatives and the Senate.

The Republican Party holds a solid majority in the House of Representatives (233-199). Accordingly, this has been the source of many of the fiscal stalemates that have impacted the economy over the past three years. It was the House, for example, that refused to raise the debt ceiling in May 2011 without deficit reduction. Polls suggest that the Republican majority is set to be extended further. While most polls suggest a modest increase of around 5-10 seats, a gain of 13 seats or more would leave the Republicans with the largest majority in the House since 1928. This raises the possibility that the Democrats would struggle to regain the House in the 2016 Presidential elections.

The Senate race is much closer. Democrats currently hold a narrow majority (53-45, with 2 independents that vote with Democrats). The Senate has 36 seats up for election this time. Three are to be filled by "special election", which are expected to deliver one Democrat and two Republican seats. Of the remaining 33, 20 are Democrat, with 9 seen as competitive races, and 13 are Republican with only 2 seen as competitive. Polling suggests that Republicans should take Montana, West Virginia and South Dakota, but would still need to gain a further three seats (and not lose any) to achieve a majority. On balance, polls suggest this is likely, but with less than one week to go a number of issues, including concerns about Ebola, have left the Senate's future uncertain.

Moreover, there is an outstanding risk that the determination of who controls the Senate will not be known even after the midterms. With several State elections appearing close, there is a real possibility of individual recounts delaying the result. More fundamentally, close outcomes in Georgia and Louisiana could trigger run-off elections in either state. Louisiana's run-off would be held on 6 December, and Georgia's on 6 January – three days after the 114th Congress is scheduled to begin. This sort of uncertainty would not be welcomed by markets.

More intransigence, less belligerence?

Yet the upcoming elections have led to relatively little concern in financial markets, despite the prospect of President Obama spending the last two years of his Presidency with a Republican Congress. This likely reflects the resignation that neither a small Democrat nor Republican majority Senate will unlock the political gridlock that has blocked legislative progress in recent years, but that this will not in itself have a severe market effect. This certainly would appear the case if the status quo is maintained, but one could envisage a Congress united under a Republican majority as even more intransigent with the White House.

Greater intransigency could effect a number of policy areas, including defence, energy, immigration reform, the appointment of a new Attorney General and climate change, for example. However, these issues are of only peripheral interest to markets in the short-term.

Further gridlock in Congress could also impact fiscal policy, more directly relevant to markets. Indeed, a Republican led Congress is likely to continue to press policy in a direction contrary to Congressional Democrats' and the White House's ambitions. This is likely to make long-term compromises all the harder to achieve and could be consistent with renewed fiscal tensions.

However, to our minds, markets broadly expect this ongoing intransigence. This is particularly the case with Presidential Elections in two years' time and primaries that begin in 14-months' time. We are resigned to the prospect of little long-term policy progress over the next two years as Party's position themselves for the 2016 election. But hope to see improvement thereafter.

We also note that, despite the current climate of intransigence, some key fiscal measures have still been enacted. These have included executive orders to restrict "tax inversions" and a "continuing resolution" to keep the government operating despite being unable to agree on a FY2015 Budget. Political gridlock has not totally frozen policy initiatives.

Perhaps most fundamentally, while we might expect political intransigence to rise, there is some hope that Congressional belligerence is waning. This may reflect:

i. The gradual narrowing of the US fiscal deficit to 2.8% of GDP in FY 2014 – the smallest shortfall since 2007 – making it less of an issue.

ii. Mainstream Republicans reasserting control over the party as the Tea Party caucus has fallen from the ascendancy.

iii. The growing focus on the Presidential Elections is likely to leave Republicans wary of being portrayed as “obstructive” and risking a deterioration in the polls – as seen in recent fiscal clashes.

iv. Reports that Senate Republican Leader Mitch McConnell does not want any issues carrying over into the new session of Congress, to provide Republicans a ‘clean slate’ for 2015.

A less belligerent Congress would be important with key fiscal deadlines looming. The government presently operates under a “continuing resolution”, which expires on 11 December. Further progress will be needed to reach agreement on Budget FY2015 (or ongoing continuing resolutions) to avoid a repeat of last year’s government shutdown. Moreover, the current debt-ceiling suspension expires on 15 March and will need to be lifted or see a renewed suspension sometime thereafter (although the Treasury would likely be able to manage well into the second half of 2015 before this constraint began to bite). A less confrontational Congress will be necessary to avoid repeating the debt-ceiling, fiscal cliff and government shutdowns of recent years, that we believe weighed on economic activity, particularly small business confidence.

Beyond fiscal issues

There are likely to be a number of other consequences of November’s elections. While markets may attach second order importance to these for now, some may yet prove a boost to economic activity over the longer term.

US efforts to negotiate far-reaching trade agreements with Japan and other Pacific Rim economies and separately with the EU have been curtailed by Congress. Congress has failed to formally grant the President the “trade promotion authority” required, mainly because of Senate Democrat opposition. The midterms look set to deliver a more ‘trade friendly’ Congress. Either as the Republicans, which are historically more pro-trade, gain a majority, or as Senate Democrats have suggested they may be less opposed to granting this permission in the event that they retain the majority.

Defence and energy polices could also develop. Given rising tensions globally, Congress and the White House may be able to find some common ground on further funding for “overseas contingency measures”, particularly as the focus of this is likely to broaden beyond military exercises in the Middle East to Ebola prevention in Africa and “assistance” for Ukraine.

Markets may also assume that a Republican Senate would be less aggressive when it comes to implementing new regulations on the financial sector designed to bolster financial stability. Some reports suggest the Republican Shelby would lead the Senate Banking Committee. Shelby fought against the drafting of the Dodd-Frank reform act in 2010. This may provide some relative optimism to the financial sector.

Conclusions, or the beginning of the end

Markets do not seem too concerned about the upcoming midterm elections. We argue that, in the main, this is with good cause: whether the Senate has a slim Republican or Democrat majority from next year, we still expect political deadlock ahead of 2016’s Presidential Elections. More important will be how belligerent both parties choose to be over the next two years, but we argue there are hopeful signs of more grudging cooperation emerging in Congress’ 114th session. Moreover, markets have had more pressing concerns in recent weeks, with a persistent decline in stocks and yields since the summer, culminating in severe stresses two weeks ago.

However, there are economic benefits that could emerge from next week’s midterms. Most important would be a reorientation of the Senate to provide fresh impetus to Trans-Pacific and Transatlantic trade negotiations. Both provide the prospect of lifting US and global activity over the medium-term.

We also note that the midterms mark an interesting point in the political cycle for equities. Historically equities have made some of their largest gains over the political cycle in the quarters around midterm elections, which should argue for markets attaching somewhat greater significance to the upcoming polls.

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