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Key highlights:

- It's finally here! The most important election of our time (again).
- Under the most likely scenario (Dems win House, GOP retains Senate), legislative gridlock would probably ensue which has historically boded well for equity markets.
- But, given last month's market sell off, could this time be different?

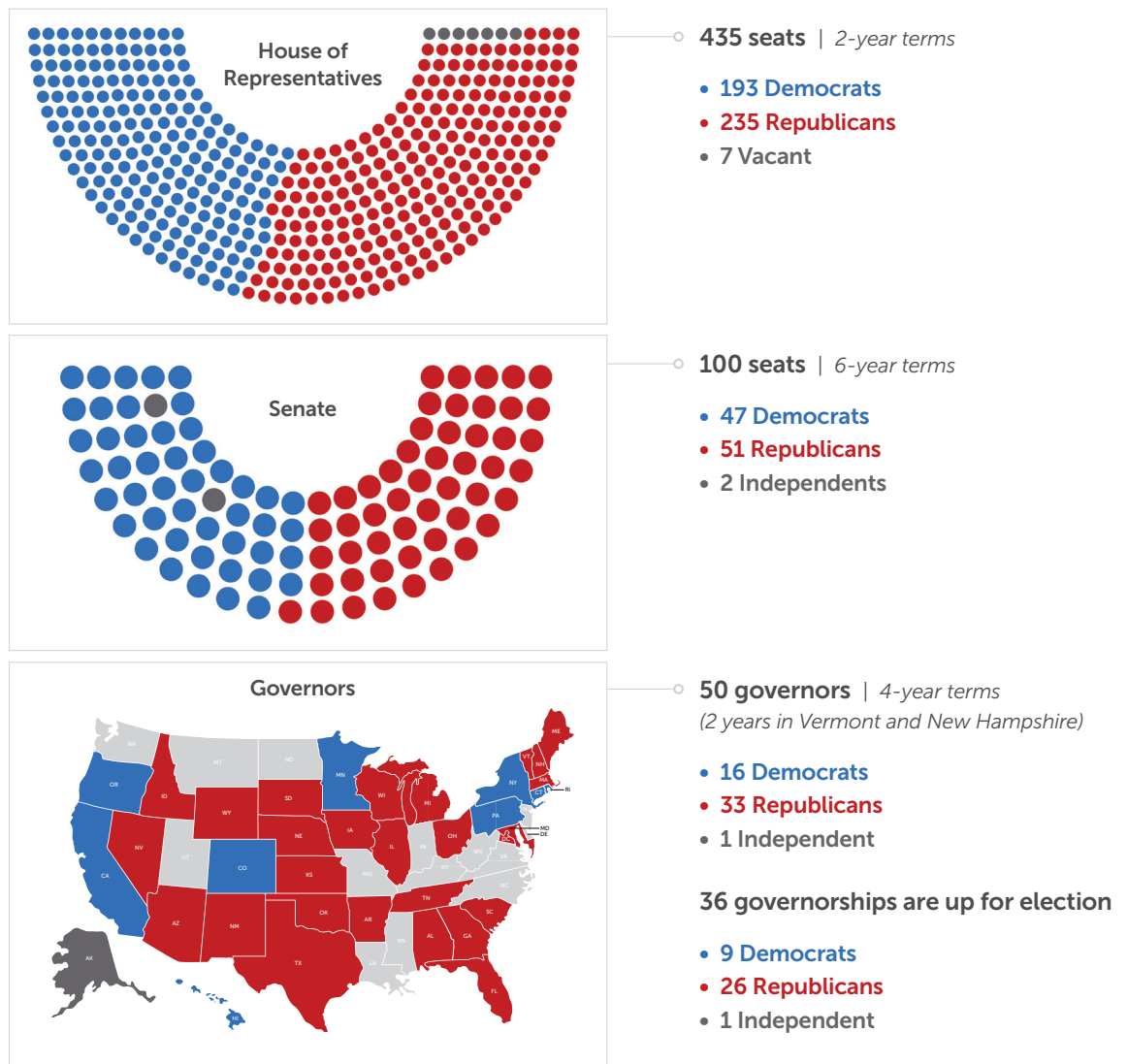
Midterm elections snapshot

"No man's life, liberty, or property are safe while the Congress is in session." -Mark Twain

We have now reached Election Day 2018, having already heard armies of pundits trying to forecast market reactions to the potential outcomes. It's important to remember that midterm elections serve as bellwethers for a sitting president's policies from the preceding two years. With that in mind, Tuesday's midterms will have a significant impact on many issues including taxes, healthcare, immigration and the overall economy. Today, there are seats in the House and Senate up for grabs as well as a number of governorships (see *Exhibit 1*). The likely winning candidate is often dependent upon geographical considerations, i.e., rural seats with higher employment in agriculture or manufacturing may take a different path than an urban seat which reminds us of Tip O'Neill's famous words that "all politics is local".¹

Exhibit 1: Where are we now?

Current split between Republicans and Democrats



Source: U.S. House of Representatives Press Gallery, United States Senate and National Governors Association, 2018.

¹ Thomas "Tip" O'Neill was Speaker of the U.S. House of Representatives from 1977 to 1987, representing northern Boston, Massachusetts, as a Democrat.

What might happen on election night?

We envision, as many observers do, three possible scenarios, as shown in *Exhibit 2*. An all-Republican win would likely be viewed as market friendly but is now being heavily discounted by political operatives in both parties. If the GOP were to maintain an outright majority in both bodies, although with anticipated losses of some seats, sectors such as Energy, Defense and Financials might outperform. A less probable all-Democratic win, with that party seizing both the House and Senate, would probably be seen as negative for markets due to the expectations surrounding their less-than-friendly business policies. Democrats would be expected to try to undo as much of the Trump agenda as possible, up to considering possible impeachment hearings, however, they are likely to be receptive to the president's plan to update the country's infrastructure which has mainly sat on the political sidelines. In this instance, we would expect infrastructure, renewable energy and drug stocks to perform well.

The third and **most likely outcome is the Democrats obtaining control of the House**. Under this scenario, a divided Congress would inevitably lead to more gridlock, which historically has been supportive for financial markets. Essentially, under this scenario, the assumption is that Washington lawmakers cannot agree to anything of significance and leave markets largely as they found them. However, it is possible that equity markets could sell off, partially driven by the market realizing that the president's proposed new 10% middle-class tax cut would be in jeopardy with a Democrat-majority in the House.

Exhibit 2: Election outcomes (in order of likelihood)

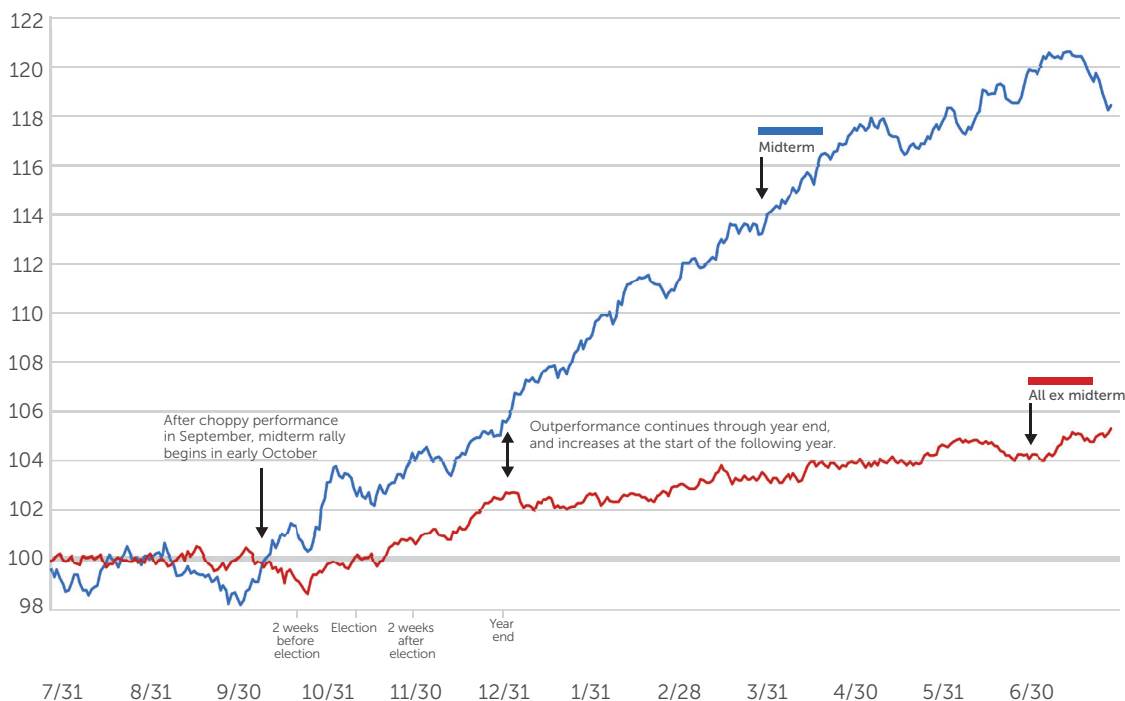
	Outcome	Probability	Equity reaction	Benefiting sectors
1	House flips to Democrats, Senate stays Republican	High	Somewhat bullish	Pharmaceutical, defense, renewable energy
2	GOP holds control of both House & Senate (with a narrower House majority)	Medium to Low	Very bullish	Energy, defense, financials
3	Democrats sweep House and Senate	Low	Bearish	Pharmaceutical, defense, renewable energy, infrastructure

Is this time different?

As shown in *Exhibit 3*, markets, specifically the S&P 500 Index, typically surge during the post-election period regardless of the outcome and that rally usually starts before the election in October. However, given last month's selloff in equity markets which is atypical during an election cycle, this time feels a little different. Political observers are quick to point out that each election is unique and, hence, it is very difficult to predict the outcome, political or financial, with any level of certainty. We need only recall that most major networks and polling firms expected Hillary Clinton to be the 45th President of the United States. Our thought is that, as so much has been unpredictable during this administration's first two years in office, the market's reaction to the results may well surprise us.

Exhibit 3: How does the equity market typically react to midterm elections?

S&P 500 performance around midterms vs all other years (average since 1970)



Source: Bloomberg, 10/31/18. Based on returns from 1/70-10/18.

A parting word

No matter which way the races go, Trump is unlikely to back down on his protectionist policies. In fact, additional tariffs on China totaling \$267 billion are still expected as the White House largely controls national trade policy. A deal must still be made with China but it is possible that this will not happen until closer to the Presidential election in 2020. We suggest that investors also keep an eye on potential tax reform, possible attempts by a Democratic-controlled House to investigate the president and his administration, and any accompanying market volatility.

The **Standard & Poor's 500 Index (S&P 500)** is a capitalization-weighted index of 500 stocks. The Index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. It is not possible to invest in an index.

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