

Anticipating the US midterm results

Weekly Market Compass: Short-term volatility is likely, but what could results mean for the longer term?

Nov 5, 2018 | Kristina Hooper, Chief Global Market Strategist

October has come to an end - and what a miserable month it was for stocks. The Dow Jones Industrial Average fell more than 5%, the S&P 500 Index lost 6.9% (its worst month in seven years), and the Nasdaq Composite Index dropped 9.2% (its worst month since November 2008).¹ Looking beyond the US, the MSCI EAFE Index gave up 8% during the month, while the MSCI Emerging Markets Index lost 8.7%.¹ And beyond stocks, major bond indexes such as the Bloomberg US Aggregate Bond Index and the FTSE Russell Emerging Markets Broad Bond Index also gave up some ground.¹ Real estate investment trusts lost 3% as represented by the MSCI REIT US Index, while commodities lost 2% as represented by the Bloomberg Commodity Index.¹ One of the few bright spots in October was gold, with spot prices rising 2.8%.¹

Risks abound for global markets

Markets have good reason to be nervous, thanks to monetary policy tightening and geopolitical risk.

The United Kingdom has been a poster child for geopolitical risk. It doesn't appear much progress was made last week vis-a-vis Brexit negotiations, and the clock continues to tick. However, Standard & Poor's announced last week that a "no-deal" Brexit could push the UK into a moderate recession and lower its long-term growth potential. Standard & Poor's projected unemployment in the UK in a 'no deal' Brexit scenario could rise to more than 7%, home prices could drop 10% and households could lose an average of 2,700 pounds in income per year as soon as 2019.² S&P's report is an important reminder of the dangers of this kind of geopolitical risk.

Of course, the greatest geopolitical uncertainty is trade. Risk assets rallied last week after US President Donald Trump tweeted that he had a very productive call with Chinese President Xi Jinping. I was very skeptical of the tweet, as China and the US have been miles apart in terms of this issue. As we have seen time and again, investors have been all too willing to cheer any signs of even slight improvement in the trade situation - but reality took hold quickly as other signs emerged that the trade situation has not improved. For example, the US Justice Department unveiled criminal charges on Thursday against Chinese and Taiwanese companies for trade-secret theft. It is clear that the US is ratcheting up the pressure on China rather than taking a more conciliatory approach.

I believe we saw another canary in the coal mine on trade with the most recent US ISM Manufacturing number that was released last week. While the ISM Manufacturing Index remained strong for October, it experienced a significant drop from September - which indicates a slower rate of growth.³ In particular, the New Orders Index clocked in at 57.4%, a decrease of 4.4 percentage points from the September reading of 61.8%.³

The report included several comments about the negative impact of tariffs on several different industries:

- **Chemical products:** "Tariffs are causing inflation: increased costs of imports, increased cost of freight and increased domestic costs from suppliers who import."
- **Miscellaneous manufacturing:** "Mounting pressure due to pending tariffs. Bracing for delays in material from China - a rush of orders trying to race tariff implementation is flooding shipping and customs."
- **Petroleum and coal products:** "Steel tariffs continue to negatively affect our cost, even though we utilize U.S. sources for steel."

Having said that, any negative impact from tariffs has not yet shown up in US employment data, as the October jobs report was a blowout. Nonfarm payrolls created was a very impressive 250,000.⁴ However, as usual, my focus was on wage growth. And, for the first time in nearly a decade, year-over-year average hourly earnings rose more than 3%.⁴ I have been of the opinion that 3% is a key level – and that stocks would react negatively if average hourly earnings rose to that level or above, because it raises the specter of more and faster tightening by the US Federal Reserve (Fed). And that's exactly what happened last Friday, as it seems increasingly likely that the Fed may raise rates for a fourth time in December.

Looking ahead to the US midterms

This week will be all about the US midterm elections. I have gotten so many questions on what the implications are for markets. Before I share my view, I feel compelled to remind investors of an old adage: In the short run, the stock market is a voting machine – and that's when we often see investors making knee-jerk reactions to developments such as elections. It is only in the longer term that the stock market is a weighing machine that may more appropriately price in developments such as elections and the ensuing policy agenda that results.

What if the House goes to the Democratic Party?

Let us start with the base case scenario ascribed to by most pollsters – a Republican Senate and a Democratic House. If this scenario happens, I wouldn't be surprised to see an initial negative reaction by the stock market on the theory that a Democratic House could represent a significant roadblock for the Trump administration in achieving its agenda. But while the Trump administration's agenda in the first year was very pro-growth, and stocks reacted accordingly, the second year has seen an emphasis on policies that can run counter to economic growth – primarily protectionism – and stocks have posted very different returns thus far this year.

And so, while there may be an initial sell-off if Democrats take the House, I wouldn't be surprised to see stocks ultimately react more positively to the prospect of greater checks and balances on the administration's agenda – especially if Congress attempts to claw back some of its power over tariffs from the executive branch. (Keep in mind that the US Constitution granted the power to levy tariffs to the Congress, but Congress has been giving away its powers over trade to the executive branch over the last 80 years). There is also the possibility that after the midterm elections, especially if the House goes Democratic, the Trump administration may worry that its trade policies could cause the economy to weaken, which in turn could result in a presidential election defeat in 2020. Therefore, the administration could take a more conciliatory posture with regards to its burgeoning trade wars.

There is also a decent chance, in my view, that a Democratic House could work with Trump on a significant infrastructure spending bill. I am very positive on infrastructure spending because 1) it could be very stimulative for the economy with a high multiplier effect; and 2) it represents the nation's capex spending. I believe the US has not invested enough in itself, and its infrastructure is in poor shape as a result (by comparison, China's infrastructure is in far better shape). Just as a company's capex spending can be critical to its future economic growth, so can a country's capex spending, especially in areas such as telecommunications and transportation. And so there is actually potential for upside if the House goes Democratic.

What if the House stays Republican?

If the House stays Republican, I believe there may be a short-term relief rally, but it would likely be short-lived. In terms of policy, I expect the Republicans' first order of business would be to make permanent those elements of Trump's tax reform legislation that have a sunset provision. I believe the stock market would react very positively to this development in the shorter term, but would become more negative as it factored in the growing federal deficit, especially since making existing tax cuts permanent is unlikely to boost economic growth significantly in the shorter term, in my view. I also believe a Republican-led Congress may attempt to deliver a middle-class tax cut, which could be stimulative – although I expect substantial resistance from deficit hawks in Congress.

What about the Senate?

While it appears extremely unlikely that both chambers of Congress could flip Democratic, I believe that scenario would definitely cause a negative reaction in the markets as it introduces the possibility of impeachment.

In summary, it is far easier to anticipate how the stock market may react to the election in the very short term versus its longer-term reaction – especially since, over the longer term, myriad factors impact markets, including Fed policy. I do believe midterm election results have the potential to create both upward and downward volatility in the shorter term.

As for the longer term: Importantly, no matter the result, there is a path forward to enact policies that could potentially help the economy, as well as to continue conflicts that could stall progress. No matter which party comes out on top tomorrow, my hope is that the winners will focus on the areas that can make a true difference in our economy, rather than the ones that simply garner the most headlines.

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Source

¹Source: Bloomberg, L.P., data from Oct. 1, 2018, through Oct. 31, 2018

²Source: Standard & Poor's, "Countdown to Brexit: No Deal Moving Into Sight" Oct. 30, 2018

³Source: Institute for Supply Management, Nov. 1, 2018

⁴Source: US Bureau of Labor Statistics, Nov. 2, 2018

Important information

The Dow Jones Industrial Average is a price-weighted index of the 30 largest, most widely held stocks traded on the New York Stock Exchange.

The S&P 500® Index is an unmanaged index considered representative of the US stock market.

The NASDAQ Composite Index is the market capitalization-weighted index of approximately 3,000 common equities listed on the Nasdaq stock exchange.

The MSCI EAFE Index is an unmanaged index designed to represent the performance of large and mid-cap securities across 21 developed markets, including countries in Europe, Australasia and the Far East, excluding the U.S. and Canada.

The MSCI Emerging Markets Index is an unmanaged index considered representative of stocks of developing countries.

The Bloomberg Barclays U.S. Aggregate Bond Index is an unmanaged index considered representative of the US investment-grade, fixed-rate bond market.

The FTSE Russell Emerging Markets Broad Bond Index measures the performance of both investment-grade and high-yield US dollar denominated debt issued by governments, regional governments, government-sponsored entities, and corporations domiciled in over 60 emerging markets.

The MSCI US REIT Index is a free-float-adjusted, market capitalization index that is composed of equity REITs.

The Bloomberg Commodity Index is a broadly diversified commodity price index.

The ISM Manufacturing Index, which is based on Institute of Supply Management surveys of more than 300 manufacturing firms, monitors employment, production inventories, new orders and supplier deliveries.

Capital spending (or capital expenditures, or capex) is the use of company funds to acquire or upgrade physical assets such as property, industrial buildings or equipment.

A spot price is the current market price at which an asset is bought or sold for immediate payment and delivery. In a "no-deal" Brexit, the UK would leave the EU in March 2019 with no formal agreement outlining the terms of their relationship.

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