
Five issues for investors to watch

Weekly Market Compass: Can a split US Congress find agreement on policy? Is India due for a central bank shakeup?

Nov 12, 2018 | Kristina Hooper, Chief Global Market Strategist

Last week, the US experienced a deepening split in political leadership, which dominated headlines. And yet, that was just the tip of the iceberg in terms of events that are impacting global markets. Below, I recap five key events from last week and highlight five issues to watch moving forward, including whether there are grounds for new alliances among US President Donald Trump and the Democratic House.

Five key events from last week

1 US midterms. Americans went to the polls for US midterm elections and rendered a change in the composition of the US Congress. It was a unique outcome, with the US House of Representatives' majority turning Democratic and the US Senate's Republican majority becoming more entrenched. This has some interesting implications that could be positive, in my view.

First and foremost, the election outcome means that the administration's nominees can be more easily confirmed. The Senate has been referred to as the "personnel department" of the US government, as it is the body responsible for confirming all high-level appointments by the executive branch. Given the larger Republican majority, the Senate will be able to continue confirming Trump's nominees - and the process is likely to be smoother than we saw during the recent confirmation hearing of Supreme Court Justice Brett Kavanaugh. This means that the administration's efforts toward deregulation can continue - and potentially accelerate, which I see as a positive for economic growth. In addition, there are other opportunities for economic stimulus - most notably infrastructure.

2 FOMC meeting. I would argue that last week's US Federal Reserve (Fed) meeting was the least-watched meeting in years as most investors were preoccupied with the US midterm elections. However, the Federal Open Market Committee (FOMC) announcement was a rude awakening - investors were reminded that the Fed is very much "business as usual," as it remains on track for a rate hike in December and more in 2019.

3 Oil price drop. Oil prices continued their drop last week, falling into bear territory with a price drop of more than 20% for West Texas Intermediate crude, while Brent crude has fallen 19% since Oct. 3. There has been fear that this drop suggests falling demand as a result of an economic slowdown. However, I believe this is more a supply issue. Keep in mind that a nervous Trump administration eased rules on other countries' ability to purchase oil from Iran in order to prevent oil prices from rising and hurting US consumers - which was especially important in advance of elections. However, as this week starts, oil prices have risen as Saudi Arabia has stated it will begin cutting oil production in December.

4 Peso volatility and Mexican stock market drop. Incoming Mexican President Andres Manuel Lopez Obrador (AMLO) has already started to shake things up before even taking office. In the last two weeks, the populist politician has announced the cancellation of the \$13 billion Mexico City airport project and the abolishment of ATM fees, both of which have caused significant volatility in the Mexican peso and Mexican stocks. In particular, the ATM fee announcement caused the IPC Mexico Stock Market Index to experience its biggest one-day sell-off since 2011.¹ I expect this greater currency and stock market volatility to continue after he takes office.

5. China concerns. Last week saw renewed concerns about China after the People's Bank of China warned in its monetary policy implementation report that the Chinese economy is facing "downward pressure." However, I continue to believe that China's economic deceleration will be modest and that there is much going well in the country. President Xi Jinping continues to underscore China's progress toward globalization and free trade, affirming in a speech last week that the country was "steadily widening the opening up" of its financial industry. And as I write this, I am overwhelmed by the amazing success of this year's Singles Day retail holiday in China, which took place on Nov. 11. Alibaba has reported² that sales for this year totaled about \$31 billion versus approximately \$24 billion for Singles Day 2017 - which further supports my view that the Chinese economy has to be relatively strong in order to see such growth in sales.

Five issues to watch

- 1 The Italian budget.** The world will be watching as Italy must submit a revised budget to the European Commission on Tuesday. I don't expect Italy to get much more fiscally conservative in this iteration of its budget; the question is how the European Union (EU) will react. I expect more volatility and widening spreads as the war of words between Italy and the EU likely escalates. There is of course the possibility that the EU levies fines, freezes EU funds to Italy and conducts bond-sale monitoring. However, I believe Italy and the EU will ultimately reach a compromise, whereby the EU slaps Italy's wrist and makes it promise to be more fiscally prudent in future years.
- 2 India's central bank.** It has been reported that Reserve Bank of India (RBI) Governor Urjit Patel may resign at the bank's next meeting on Nov. 19 as he fights for central bank autonomy. The administration of Indian Prime Minister Mahindra Modi appears to be encroaching on the RBI's independence - in particular wanting to tap into RBI reserves to fund its fiscal deficit - and it has become significant enough that Patel may resign. I have to give the caveat that there have been tensions before between India's central bank and its prime minister, and they have abated, and so a Patel resignation is far from a done deal. We will want to follow this situation closely as Patel has been a strong and effective leader; it is unclear who would replace him if he were to resign.
- 3 The G20 meeting.** We are getting closer to the G20 meeting at the end of November, at which time a trade meeting between Trump and Xi is being planned. This past weekend, US trade czar Pete Navarro publicly expressed concern and outrage that "globalists" were putting pressure on Trump to make concessions with China and end the trade war. Navarro's comments have made me feel more positive about the trade situation than I have felt in a long time - in my view, he would not have gone public with his concerns unless he thought there was a real chance that Trump would alter his stance with China.
- 4 Brexit.** The pound has been dropping on concerns about the increasing likelihood that there will be a "no deal" Brexit. UK Prime Minister Theresa May has been under pressure to abandon her proposed Brexit plan, with speculation rampant that if it were to be voted on in its current form, it would not pass. Reportedly, May is working on revamping the plan. We will want to follow developments closely, as the potential drops for a November summit with EU leaders in which a deal could be hammered out.
- 5 US politics.** We will need to follow US political developments in the weeks and months to come. As we saw in Trump's post-election press conference last week, the combination of a Democratic House and Republican Senate could go quite poorly or very well - or both as the US may see episodic bouts of cooperation giving way to episodic bouts of intense conflict and back again. As articulated in my election coverage last week, I continue to believe there is significant potential for upside - that's because there are a few agenda items that Trump and Democrats agree on:

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- I believe there is a real possibility that the Trump administration could reach across the aisle and strike a deal with House Democrats for a significant infrastructure spending package. If that happens, I think there's a decent chance it could pass the Senate, as the Republicans in the Senate are not as hawkish on the deficit as the Republicans in the House. An infrastructure package could provide powerful stimulus for the economy in general - so if the economy does begin to slow next year, there is all the more reason we could see the administration interested in getting an infrastructure bill passed. I believe that would likely be positive for materials stocks.
 - Both Trump and the Democrats seem to agree on greater regulation - and taxation - of technology companies. In my view, we could see a sell-off in the tech sector if this view begins to influence policy. In fact, this is already exacerbating concerns about future revenue and earnings growth for tech - and those growth concerns are causing a major sell-off as I write this.
 - Additionally, both the president and Democrats agree on regulation of drug pricing. However, I don't believe Senate Republicans are likely to agree to any bill regulating drug pricing.
 - Finally, both the president and Democrats have advocated for an increase in the federal minimum wage. While I think it would be difficult to get through the Senate, if it were to pass, it would create pressure on US retailers and restaurants.

In addition, the Democratic House victory ensures that the Affordable Care Act is protected from repeal. This should continue to be positive for hospitals and insurers, in my view.

There is also the potential for the Democratic House to partner with the "free trade" Republicans in the Senate to claw back some powers over tariffs. As I have said before, the US Constitution granted the power to levy tariffs to the Congress, which gave up that power to the president over time. So it is not out of the realm of possibility for Congress to attempt to claw back some of those tariff powers from the executive branch, especially if more signs appear that tariffs are hurting the US economy. Now, it's highly unlikely that Congress will be able to achieve a veto-proof majority on this issue; however just the dramatic act of attempting to claw back powers may cause the administration to soften its stance on trade, particularly vis-a-vis China. There is some concern that, with a Democratic House and the inability to get much legislation passed, the president may focus on areas within his control (such as trade policy) and could actually become more aggressive and less conciliatory. However, I believe that's unlikely - especially if data shows tariffs' negative impact on the economy as the administration begins to focus on its prospects for re-election in 2020.

Finally, a number of investigations into Trump and his campaign and his businesses are likely to be launched in the Democratic House. And it's important to note that the House has unlimited subpoena power (which Robert Mueller does not) so this could certainly be problematic and distracting for the president. However, while the House may impeach, I do not believe that the Senate would ever convict, so the impeachment issue is a moot point, in my view.

Source

¹Source: Bloomberg, L.P., as of Nov. 9, 2018

²Source: CNN, "Alibaba Singles Day sales top \$30 billion," Nov. 11, 2018

Important information

IPC Mexico Stock Market Index tracks the performance of companies listed on the Mexican Stock Exchange.

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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