

## US midterms: a case of the blues...

The US midterms threw up some surprises, but we have a split Congress. President Trump's legislative agenda risks being constrained as a result, which will make it harder to generate a platform that will stand him in good stead for a defence of his presidency in 2020



US President Donald Trump

### A blue wave... In the House...

Few pundits thought the Republicans had much of a chance of holding onto the House of Representatives in the build-up to the election. After all incumbent Presidents typically see their party lose seats (only three out of the last 21 midterm elections have seen gains) and according to data compiled by Gallup, President Trump was the least popular president at this stage in a presidency since Harry Truman in 1950. At the same time, the Democrats were ahead in generic polling by around 7-8 percentage points and managed to raise more money in key battleground constituencies while the Republicans also experienced a relatively large number of high profile retirees, including House speaker, Paul Ryan. As such the question on most people's lips was how big the "blue wave" would be.

The Democrats are projected to make a net gain of 34 seats, [according to FiveThirtyEight](#), which is more than the 23 they need to win control of the House.

However, it was a different story in the Senate with the Republicans actually gaining seats to leave

them with an enlarged majority - it could be as many as five extra Senate seats. So, while not a great night for the Republicans, they can take solace in the fact that they prevented a Democrat sweep that could have completely blocked both the President's legislative agenda and any appointments to federal courts, new cabinet members and the Federal Reserve.

The Democrats could also have used the additional political momentum of winning the Senate to really step up the threat of impeachment proceedings against the President. By not succeeding here, the mathematics make getting a successful impeachment look a remote possibility, barring overwhelming and incontrovertible evidence of malfeasance.

## Trump tapered

Even so, life is going to get far tougher for President Trump. The split Congress (Democrat House and Republican Senate) means that there is more likely to be gridlock, which will significantly curtail his legislative agenda. Bi-partisan action may be possible in areas such as infrastructure spending, but for the most part divisions between and within the parties mean that progress will be difficult. For example, President Trump's proposal on additional income tax cuts has received a major blow because of the election result.

Faced with this, the President is likely to focus his attention on areas where his executive powers give him more leeway to set the agenda, such as trade policy. This suggests that he is likely to continue pushing hard on China to make concessions that will contribute to getting the bilateral trade deficit lower and do more to protect US intellectual property rights. However, China's response so far (the massive fiscal stimulus announced last week points to China digging in for a long attritional battle) leaves us sensing that tensions will likely escalate further in the near term, with tariffs being increased and broadened next year.

This in itself may well get backing from Democrats, but they are likely to be more resistant to starting a trade war with traditional allies such as the European Union or pulling out of the World Trade Organisation. Instead, we may get more discussion about working together with Europe in order to stand a better chance of getting movement from China on trade.

There is, of course, the remote possibility that President Trump and the Democrats choose to bury the hatchet and work together - both President Trump and current Democrat House minority leader (likely next House Speaker) Nancy Pelosi have called for bi-partisanship in the wake of the results. This could unleash additional fiscal spending, particularly on infrastructure, while allowing potentially for more tax cuts as long as they are targeted at lower income households. This would be a positive for growth, but given the hostile and polarised nature of Washington politics right now this would be an uneasy truce.

## What now for fiscal policy?

Historically we have typically seen federal budget deficits get larger during Republican presidencies and get smaller under Democrat presidents. This trend has continued under President Trump. The Congressional Budget Office estimates that the US Federal deficit will widen out to 4.6% of GDP next year at a time when the economy is booming and the unemployment rate is at 50-year lows. The massive fiscal stimulus introduced by the President this year is leaving a hole in the government's finances and there are legitimate questions starting to be asked about longer-term fiscal sustainability. After all, if the US was to experience an economic shock with lower growth or even a recession, the deficit could quickly balloon back towards the 7-9% of GDP deficits

experienced in the aftermath of the global financial crisis.

However, the fact that the Democrats control the House means that there is a reduced prospect of additional fiscal expansionary policy initiatives. In turn, this may help to ease the debt sustainability fears, but they won't subside completely. There will be a bigger threat of potentially disruptive government shutdowns given differences of opinion on government funding. In addition, President Trump's criticism of the Federal Reserve's interest rate increases will continue, but that will continue to be shrugged off by policymakers.

## Impeachment looking less likely

This was a topic never far away from political commentators in the build-up to the vote. The most plausible scenario would be if special counsel Robert Mueller found direct and incontrovertible evidence of Russian interference in the 2016 election. Of course, now that the Democrats have control of the House they can launch Congressional investigations with subpoena power, which could heighten talk of possible impeachment proceedings - we are also likely to see renewed demands for the President to release his tax returns. To start impeachment proceedings against the President would require a simple majority in the Democrat-led House, but it requires a super majority of 67 Senators, where the Republicans now hold a larger majority.

As such, based on the numbers as they currently stand this would need around 20 Republican Senators to cross the floor and vote with the Democrats. This seems unlikely, especially if they believe President Trump can pardon himself - as he has stated. Given this situation, the Democrats may be reluctant to act quickly and even if they do pull the trigger there is a strong likelihood Donald Trump would be found not guilty.

## Market reaction

Market reaction has been fairly muted. US stocks opened about 1% higher, continuing a recent rally, while bond yields also rose and the dollar was slightly lower. Had the Republicans retained control of both the House and Senate then we would have expected a bigger bounce in US equities, Treasury yields, and the dollar. This would have been on the basis of a greater prospect of additional fiscal stimulus with the Federal Reserve responding to the stronger growth and inflation environment by raising interest rates more aggressively. There would have also been more worries about US fiscal sustainability.

However, the results mean that we wouldn't be surprised to see a slight drift in the opposite direction given the expectation of more limited room for manoeuvre on fiscal policy. That said, President Trump will not be scaling back his protectionist policies anytime soon and there is a chance of bi-partisanship on some pro-growth strategies such as infrastructure. Moreover, the growth stories outside of the US aren't looking particularly robust right now so it is hard to see a dramatic rotation into overseas asset markets on the back of these results.

## President Trump feeling blue

While not a great outcome for President Trump, it could have been worse. He clearly had plans to press on with infrastructure spending and further tax reform in the second half of his presidential term and while the policies are not dead, they are likely going to be curtailed or heavily revised by a Democrat-controlled House. Bi-partisanship will be required for progress to be made and for President Trump to generate a strong platform to defend his Presidency in 2020.

However, the US economy will face an increasing number of challenges over the next couple of years as support fades from the fiscal stimulus and weaker global growth (contributed to by President Trump's trade protectionism), a stronger dollar and higher interest rates provide increasing headwinds. A weaker economy and potentially falling asset prices and household wealth would compound the problems for President Trump.

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