November 11, 2022

INSIGHTS

INTERPRETING MIDTERM ELECTIONS

Votes are still being counted in a number of districts around the country, but it appears the results of Tuesday's midterm elections will mean more divided government for the next two years. History has demonstrated that markets tend to thrive in such political conditions, but nonetheless investors are wise to evaluate past results with the current environment.

An Initial Reaction to Tuesday's Results

The margin will be narrower than many anticipated, but it appears that Republicans will soon hold a majority in the House of Representatives. Control of the Senate is still much more uncertain and could hinge on a runoff in Georgia several weeks from now. Regardless, the most likely outcome will be an oppositional and at times antagonistic relationship between Congress and the President.

Because the markets expected this outcome, it has reacted somewhat quietly to actual election results. This means that investors can refocus their attention on the factors that will continue to influence asset prices: inflation, interest rates, and the odds and impact of a recession.

Recent History of Markets and Divided Government

Divided government is not new to U.S. politics or to investors. Both Presidents Clinton and Obama encountered congressional opposition during most of their time in office. Yet the late 1990s and mid-2010s experienced economic expansion and produced excellent investment returns.

Under President Clinton, from election night 1994 – when Republicans assumed control of both houses of Congress – to the end of his presidency, the S&P 500 produced an annualized return of 20.7%. Under President Obama, from the midterm election of 2010 – when Republicans regained a majority in the House and made gains in the Senate – to the end of his presidency, the S&P 500 generated a13.3% annualized return.

Will History Repeat Itself?

The examples above are encouraging, but there are several key differences between the political and economic backdrops of then and today. For example, in November 1994, inflation was at 2.7%; in November 2010, it registered an extremely low 1.1%. As of yesterday, inflation stands at 7.7%, and while it appears to have peaked, the Fed is ratcheting up rates no matter who controls Congress.

Another key difference is in the level of partisan politics. To his credit, President Clinton responded to the 1994 midterm results by taking a moderate stance and working with Congress to move the country forward. The current political tenor makes it seem unfathomable, but President Clinton and a GOP-controlled Congress worked together to reform welfare, control Medicare spending, reduce the capital gains tax, and expand free trade. While President Obama and congressional Republicans agreed on much less, the end result was lower federal government spending, smaller budget deficits, and an extension of the Bush tax cuts enacted the decade before.

continued on page 2

Focusing On What's Important

Politically speaking, the next two years will be rife with congressional gridlock, strong rhetoric, and little legislation passed outside of an occasional executive order from the President (in other words, more of the same). Because investors will receive little if any help from the government, they will need to monitor three things to be successful: the trajectory of inflation, changes in interest rates, and earnings.

If inflation has truly peaked and can sustain a downward trend, it will allow the Fed to slow or even end its rate hike plan. This would cause even the most uneasy of investors to breathe a sigh of relief and allow consumer confidence to stabilize. A pause in rate hikes (and eventual rate decreases) will support expanding stock price multiples and growth. Together, all these factors should promote a more bullish market stance.