After the Midterms, Steady as She Goes for U.S. Markets

The results of the U.S. midterm elections fell in line with expectations, with Democrats winning control of the House of Representatives and Republicans maintaining control of the Senate. That should spell good news for U.S. markets, although some potential risks also lie ahead, according to BMO market professionals.

"From an equity perspective, this could be a best-case scenario in terms of less rhetoric from both sides," said **Brian Belski, BMO Capital Markets** Chief Investment Strategist. "Also, stocks run on fundamentals. Earnings growth has stabilized dramatically, and we believe U.S. equities are poised for a very strong recovery heading into 2019."

The U.S. economy similarly has exhibited strong momentum. **Mike Stritch**, Chief Investment Officer of **BMO Wealth Management U.S.**, noted that the midterm results are likely to have a limited impact on that trajectory.

"There are three material ways Congress can impact a $20 trillion economy: tax policy, fiscal spending and regulatory changes," Stritch said. "All three of those levers have previously been pulled and are now tailwinds to economic growth. We are comfortable with our moderate-overweight position on risk assets, with a particularly favorable view on U.S. equities."

Equity and Currency Markets

Stritch noted that from a historical perspective, U.S. equity markets are poised for a strong run. "Going back to 1946, the S&P 500 has risen in every 12-month period following the midterms,"[1] he said. Stritch added that valuations are reasonable, while fiscal stimulus should remain a tailwind in 2019. And while October was a rough month for equity markets, the underlying fundamentals remain strong, indicating that the recent pullback is likely a temporary setback.

"Although interest rates are trending up, real rates—the difference between nominal interest rates and inflation—are still close to zero," Stritch said. "Periods of protracted stock declines also tend to correspond with periods of earnings contractions and overall recessions. While earnings growth may have slowed in the third quarter, we're still forecasting 7- to 10-percent growth for fiscal 2019, which is a very good number by historical standards."

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The October jobs report signaled that employment growth is solid while wages grew 3.1 percent year over year,[2] which should be favorable for consumer spending while inflation remains contained. But **Jon Adams**, Portfolio Manager at **BMO Global Asset Management**, warns that higher payrolls introduce potential risks.

"The Fed has indicated that they may need to raise rates above what they consider a neutral rate," Adams said. "A hike in December and two more next year would get them close to what they consider a neutral level. If they need to raise rates three or even four times next year, that could potentially weigh on equities."

On the currency side, the U.S. dollar was lower across the board in the wake of the elections. But **Greg Anderson**, **BMO Capital Markets** Global Head of Foreign Exchange Strategy, believes the strong economy and ongoing trade skirmishes—particularly with China—should be positive for the U.S. dollar on a three-to six-month horizon. "Trump has pursued this policy and it hasn't cost him much politically," he said. "For many politicians, losing the House would make them more cautious in their dealings with China in the way that Presidents Obama and George W. Bush were cautious. But Trump is not so risk averse, so this election is unlikely to change his approach."

Policy and Regulatory Issues

On the surface, a divided Congress can create policy uncertainty, said **Michael Gregory**, Deputy Chief Economist, **BMO Financial Group**. From the Democratic side, there are some calls for increased oversight of the Trump administration, which Gregory said could increase the risk of confrontation with the White House, as well as the risk of a government shutdown or a debt ceiling impasse—all of which could weigh on the economy.

Gregory added that on the legislative side, the GOP's push for further tax cuts and the rollback of the Affordable Care Act seem unlikely to come to pass, and deregulation efforts could face resistance unless environmental issues are addressed.

On the flip side, Belski pointed out that a divided Congress means President Trump retains his veto power on issues such as deregulation. He added that the curbs a split government would bring to the administration's legislative agenda could be a positive for certain sectors.

"President Trump was pushing for a full repeal of Obamacare, so we could see less pressure on drugs and biotech," Belski said. "Healthcare as a sector has outperformed this year, so that could be a positive."

Growth Despite Risks

Gregory noted that one potential area of common ground is in increasing infrastructure spending. A dollar in spending hikes is more stimulating than a dollar in tax cuts. However, major action on either front is unlikely because of the elephant in the room—the return of trillion-dollar budget deficits, representing nearly 5 percent of GDP,[3] is going to constrain any new spending or tax initiatives from our perspective.

The shift in power in the House could also introduce uncertainty around the USMCA's passage, given that Democrats have historically been less pro-trade than Republicans. Gregory pointed out that if there's doubt about approval, that would likely add uncertainty to the Canadian market outlook.

On balance, any increased political and policy uncertainty—to the extent that it undermines business and consumer confidence—could modestly dampen economic performance. But keep in mind that the U.S. economy is exhibiting strong momentum and that confidence metrics are elevated, so we don't expect any noticeable dent in economic performance because of the change in Congress. "We still anticipate economic growth slightly under 3 percent," Gregory said, "though we acknowledge a bit more downside risk around that outlook."

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[1] https://www.marketwatch.com/story/this-is-whats-happened-to-stocks-after-every-midterm-election-since-world-war-ii-2018-11-05

[2] https://www.bloomberg.com/news/articles/2018-11-02/u-s-payrolls-rise-above-forecast-250-000-as-wage-gains-hit-3-1

[3] https://www.cbo.gov/system/files?file=2018-08/53884-apb2019.pdf