November 7, 2018

U.S. Midterms—A Divided Political Verdict, But Marginally Positive for Markets?

The results of Tuesday's U.S. midterm elections were broadly in line with expectations—the Democrats notched a small majority in the House, while Republicans slightly extended their narrow control of the Senate. These outcomes substantially reduce the probability of any further fiscal stimulus (including another round of tax cuts or deficit-financed infrastructure spending) and point to intensified gridlock within the legislative branch through 2020. We see President Trump responding during the months ahead by amping up his rhetorical attacks on the Democrats and increasingly relying on his executive authorities to manage sensitive issues, such as trade, immigration, and sanctions policy. In terms of market reaction, the U.S. long bond rallied a handful of basis points and equities rallied as well (see the following section for additional market implications). Investors are accustomed to divided and gridlocked government, which was the norm through most of the Obama years, and should adapt quickly to the environment created by Tuesday's results.

The Democrats' strategy in the midterms was to attack President Trump and the Republicans on social issues (e.g., immigration, social justice, etc.), and they successfully landed some blows. But the Republicans were helped by several other factors. First, although President Trump also preferred to campaign on social issues, the economy's recent, favorable performance and strong job creation provided a consistent tailwind. And Democrats were unable to clearly articulate an alternative economic program. Second, the President remains popular with a meaningful share of the electorate. His support was material for many candidates, particularly in red states. Third, while Democrats continue to come out on top in popular vote measures, Senate Republicans are supported by their strength in many of the less populous states.

In winning the House, Democrats picked up more than the 23 seats needed to gain control of the House and are projected to have a majority.[1] This was not the "blue wave" that some Democratic partisans were hoping for, but it represented a very solid performance. A key near-term question is whether the Democratic majority will hand Nancy Pelosi the Speaker's gavel. Some of the newly-elected House Democrats are "middle of the road" in their ideology and have pledged not to vote for her as Speaker. As of yet, however, those opposed to Pelosi as Speaker have not coalesced behind a single alternative, and Democratic members may ultimately not see another way forward. As for their agenda, Tuesday's victory gives House Democrats investigative and subpoena powers, which they are likely to focus squarely on President Trump and the Administration. A key open question, which depends crucially on the forthcoming findings of the Mueller probe, is whether the House majority will eventually decide to kick-off impeachment proceedings against the President.

On a policy front, the House Democrats are likely to focus on reforming pharmaceuticals pricing, reinvigorating Obamacare, and implementing immigration reform. An open question is whether they will be willing to pass the new USMCA trade deal with Mexico and Canada. Most pundits are cautiously optimistic on this score, but it remains an open issue. On the China trade-war front, given the protectionist stance of many Democrats and the rising trend of hostility towards China among both Republicans and Democrats, the likelihood of a successful trade deal negotiation with China may have been reduced following Tuesday's results. However, Trump's need for a positive trade narrative and Democrats' opposition to trade wars with allies, makes reaching trade deals with friendly trade partners, such as Canada, Japan, and the EU more likely in the coming months.

Maintaining control of the Senate gives Trump scope to continue to get his appointees confirmed. His judicial nominations are particularly important to many of his supporters and will likely be a key issue for him going into 2020. Control of the Senate also effectively takes the risk off the table that the Senate would convict the President following a House impeachment vote, except under the most dire of circumstances. Finally, to the extent that the Republicans grow their majority, it could reduce the influence of swing voters within the caucus, such as Lisa Murkowski and Susan Collins. Given this and the retirement of Bob Corker and Jeff Flake, two sometimes dissenting voices, the Senate Republicans may be moving to a more pro-Trump position and somewhat further to the right. One wildcard, however,

[1] *Several races have yet to be called as of Wednesday, but will not affect the outcome of House control.*

is what tone the newly-elected Senator from Utah, Mitt Romney, will strike and how he will position himself within the caucus.

The implications of Tuesday's elections for 2020 strike us as distinctly unclear. Trump will claim victory because Republicans held the Senate. And over the past 70-plus years, the president's party has typically lost an average of 25 House seats in all midterm elections.[2] Thus, Tuesday's outcome is broadly in line with historical experience. Moreover, the emergence of the Democratic House majority—and the likely return of Nancy Pelosi as speaker—creates a clear foil and point of attack for the President. We see him doubling down on his rhetoric in the months ahead. But Democrats will also claim victory, pointing to their success in the House and the fact that the President is perceived negatively by many voters. The challenge for the Democrats over the next two years will be to unite behind a single candidate. The slate of possible contenders remains numerous.

Market Implications: Less Bond Market Fear, a Bit More Search for Yield?

While the outcome of the election leaves the political situation in Washington more complex, if anything, the implications for the markets may be more straightforward. The introduction of gridlock will presumably decrease the odds of another stimulus package,i.e. tax cut 2.0. And while fiscal stimulus may be a plus for growth in the near term, the increased issuance and long-term risks to the U.S. credit rating from a swollen deficit may have outweighed any benefit. As a result, the confounding of further stimulus may lead to less fear of an overheating economy and less fear of burgeoning U.S. Treasury supply in the bond market, therefore, decreasing upward pressure on rates. Furthermore, political gridlock may decrease the odds of surprise legislation, which can be destabilizing for the markets.

The two stimulus packages that mushroomed in short order less than a year ago likely contributed to the rise in rates, the steep slides in stocks and riskier fixed income products, such as high yield and emerging market debt. In other words, a slower policy track in DC should tranlsate into fewer surprises/less uncertainty for the markets. So, if the marginal impact of the election is less spending and a more predictable policy outlook, that should lead to a reduction in volatility and reduce the odds of a higher track for interest rates.

In terms of the bond market outlook, we believe the outcome of the midterms increases the odds that the 10-year Treasury will be capped at 3.25% rather than 3.50%. Combined with the moderate economic picture, this may increase the attraction of fixed income. After the strong flows in recent years, retail interest has ironically dropped off now that interest rates have risen 200 basis points from their lows. To the extent that the election results suggest that we're past the peak point for stimulus and market volatility subsides, this may contribute to a return to a "search-for-yield-lite" environment.

[2] *According to Gallup.*

Source(s) of data (unless otherwise noted): PGIM Fixed Income as of November 7, 2018

PGIM Fixed Income operates primarily through PGIM, Inc., a registered investment adviser under the U.S. Investment Advisers Act of 1940, as amended, and a Prudential Financial, Inc. ("PFI") company. PGIM Fixed Income is headquartered in Newark, New Jersey and also includes the following businesses globally: (i) the public fixed income unit within PGIM Limited, located in London; (ii) PGIM Japan Co., Ltd. ("PGIM Japan"), located in Tokyo; and (iii) the public fixed income unit within PGIM (Singapore) Pte. Ltd., located in Singapore. Prudential Financial, Inc. of the United States is not affiliated with Prudential plc, which is headquartered in the United Kingdom. Prudential, PGIM, their respective logos, and the Rock symbol are service marks of PFI and its related entities, registered in many jurisdictions worldwide.

These materials are for informational or educational purposes only. The information is not intended as investment advice and is not a recommendation about managing or investing assets. In providing these materials, PGIM is not acting as your fiduciary as defined by the Department of Labor. These materials represent the views, opinions and recommendations of the author(s) regarding the economic conditions, asset classes, securities, issuers or financial instruments referenced herein. Distribution of this information to any person other than the person to whom it was originally delivered and to such person's advisers is unauthorized, and any reproduction of these materials, in whole or in part, or the divulgence of any of the contents hereof, without prior consent of PGIM Fixed Income is prohibited. Certain information contained herein has been obtained from sources that PGIM Fixed Income believes to be reliable as of the date presented; however, PGIM Fixed Income cannot guarantee the accuracy of such information, assure its completeness, or warrant such information will not be changed. The information contained herein is current as of the date of issuance (or such earlier date as referenced herein) and is subject to change without notice. PGIM Fixed Income has no obligation to update any or all of such information; nor do we make any express or implied warranties or representations as to the completeness or accuracy or accept responsibility for errors. **Your capital is at risk and the value of investments can go down as well as up. These materials are not intended as an offer or solicitation with respect to the purchase or sale of any security or other financial instrument or any investment management services and should not be used as the basis for any investment decision. No risk management technique can guarantee the mitigation or elimination of risk in any market environment. Past performance is not a guarantee or a reliable indicator of future results and an investment could lose value. No liability whatsoever is accepted for any loss (whether direct, indirect, or consequential) that may arise from any use of the information contained in or derived from this report. PGIM Fixed Income and its affiliates may make investment decisions that are inconsistent with the recommendations or views expressed herein, including for proprietary accounts of PGIM Fixed Income or its affiliates.**

The opinions and recommendations herein do not take into account individual client circumstances, objectives, or needs and are not intended as recommendations of particular securities, financial instruments or strategies to particular clients or prospects. No determination has been made regarding the suitability of any securities, financial instruments or strategies for particular clients or prospects. For any securities or financial instruments mentioned herein, the recipient(s) of this report must make its own independent decisions.

Conflicts of Interest: PGIM Fixed Income and its affiliates may have investment advisory or other business relationships with the issuers of securities referenced herein. PGIM Fixed Income and its affiliates, officers, directors and employees may from time to time have long or short positions in and buy or sell securities or financial instruments referenced herein. PGIM Fixed Income and its affiliates may develop and publish research that is independent of, and different than, the recommendations contained herein. PGIM Fixed Income's personnel other than the author(s), such as sales, marketing and trading personnel, may provide oral or written market commentary or ideas to PGIM Fixed Income's clients or prospects or proprietary investment ideas that differ from the views expressed herein. Additional information regarding actual and potential conflicts of interest is available in Part 2A of PGIM Fixed Income's Form ADV.

In the United Kingdom and various European Economic Area ("EEA") jurisdictions, information is issued by PGIM Limited with registered office: Grand Buildings, 1-3 Strand, Trafalgar Square, London, WC2N 5HR. PGIM Limited is authorised and regulated by the Financial Conduct Authority of the United Kingdom (Firm Reference Number 193418) and duly passported in various jurisdictions in the EEA. These materials are issued by PGIM Limited to persons who are professional clients or eligible counterparties for the purposes of the Financial Conduct Authority's Conduct of Business Sourcebook. In certain countries in Asia, information is presented by PGIM (Singapore) Pte. Ltd., a Singapore investment manager registered with and licensed by the Monetary Authority of Singapore. In Japan, information is presented by PGIM Japan Co., Ltd., registered investment adviser with the Japanese Financial Services Agency. In South Korea, information is presented by PGIM, Inc., which is licensed to provide discretionary investment management services directly to South Korean investors. In Hong Kong, information is presented by representatives of PGIM (Hong Kong) Limited, a regulated entity with the Securities and Futures Commission in Hong Kong to professional investors as defined in Part 1 of Schedule 1 of the Securities and Futures Ordinance. In Australia, this information is presented by PGIM (Australia) Pty Ltd ("PGIM Australia") for the general information of its "wholesale" customers (as defined in the Corporations Act 2001). PGIM Australia is a representative of PGIM Limited, which is exempt from the requirement to hold an Australian Financial Services License under the Australian Corporations Act 2001 in respect of financial services. PGIM Limited is exempt by virtue of its regulation by the Financial Conduct Authority (Reg: 193418) under the laws of the United Kingdom and the application of ASIC Class Order 03/1099. The laws of the United Kingdom differ from Australian laws.

2018-5177