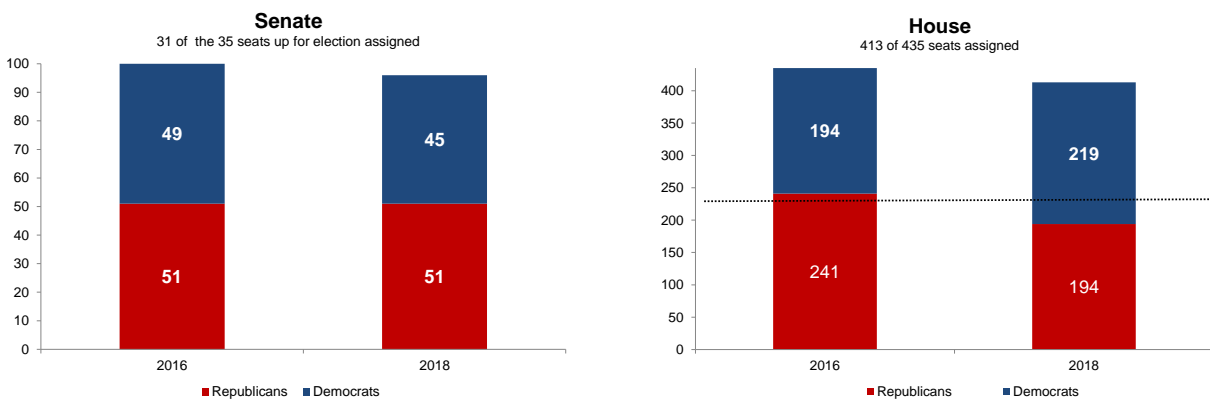


GIAM Macro & Market Research - Market Commentary

US midterm election: a split Congress

- The midterm election delivered a split Congress, with the Democrats getting the control of the House of Representatives and the Senate remaining in Republicans' hands.
- Such a scenario implies virtually no scope for big legislative action on the fiscal front. A split Congress increases the probability of a shutdown: the first such occurrence could be in Q1 2009.
- Democrats and Trump's support may increase the likelihood of extra infrastructure spending, but finding a deal in the Congress will be hard. A much more likely outcome is some revision in drug prices.
- On trade, there should be no significant impact. The new agreement with Mexico and Canada will be passed and the Administration's attitude toward China will not change.

As widely expected, the **Democrats took control of the House of Representatives, while the Republicans increased their lead in the Senate**. Democrats benefitted from a higher turnout in an election that was framed as a referendum on Trump, successfully mobilizing younger voters and minorities. The Republicans gained seats in a few traditionally Democrat-leaning states which critically switched to Trump in 2016.



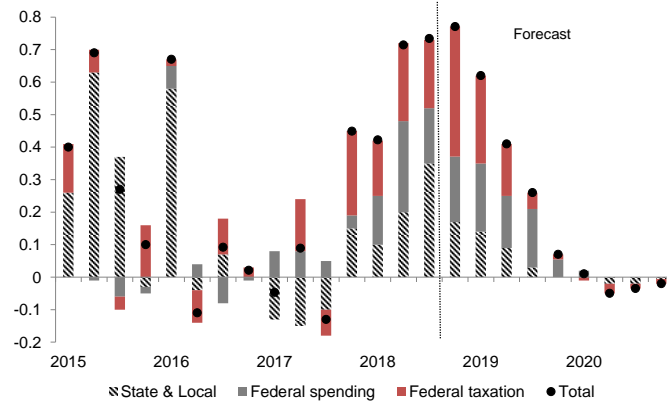
In such a situation **no party can take up any big legislative action alone and compromise will be needed**, which looks increasing difficult as the electoral results have widened the polarization of the US political system. The split Congress will be a complication for a weaker President Trump, but he was spared a full-blown defeat. The **Democratic majority in the Congress will have the possibility of carrying on investigations on sensitive issues** like Trump's tax returns and his ties with Russia. However, any bold legislation will be immediately blocked in the Senate.

In the end Trump will have to choose between taking a U-turn and seeking compromise with the opposition on a few issues like drug prices and infrastructure or escalating the conflict. However, wide-ranging investigations, very likely to be undertaken by the House of Representatives, will keep tension high.

In terms of fiscal policy a split Congress implies than no changes to the 2017 tax reform is feasible, Moreover, any increase in discretionary spending requires a 60-seat strong majority in the Senate, and no party seems to be interested in beefing up non-discretionary spending. Therefore, the positive **impact of the tax cuts and additional expenditure plans decided last year will peak in the final months of 2018 and then rapidly fade**. Under a split Congress the **possibility of a government shutdown following no agreement on spending rises markedly**. The next deadline is December 7, but it is likely to be moved to March next year or later.

Impact of fiscal stimulus on GDP growth

Source: Brookings Institutions, GIAM for the forecast



Infrastructure spending is a big priority for both the Democrats and Trump. In this area, bipartisan initiative, sidestepping the Republican Party, which is not too keen in the issue, could be a test bed for a new political climate. However, there are big differences in the proposed ways to fund infrastructure and the Democrats are probably not too willing to strike a deal before the 2020 Presidential election.

Healthcare and in particular measures to cut drug prices scores high in the Democrats priority. Trump expressed willingness to solve the issue. This may put pressure on the Senate majority to work for a compromise on the issue.

On regulation, while no legislative action appears likely, the Republican majority in the **Senate will retain the power of appointing judges and the heads of regulatory bodies**, which can advance Trump's deregulation agenda even without legislative actions. However, Democrats will control some key House committees, from which they are **likely to step up the regulatory scrutiny of some regulated industries such as health care and financial services.**

Finally, trade policy will only marginally affected by the election outcome. The new trade agreement with Canada and Mexico should be approved, even though theoretically a split Congress would make it easier for the Democrats to block it. We do not see changes in the stance towards China either, which appears to be quite popular among Democrats too.

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