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US Midterm Elections Outlook and Impact on the Financial Markets

With the critically important US midterm elections just weeks away, investors are grappling with how the balance of power may shift in Congress, and more importantly how those changes might impact the financial markets. History has demonstrated that the party out of power generally gains congressional seats during a new president's first midterm election. Indeed, with a narrow majority in the House of Representatives and an evenly split Senate, the likelihood of the Democratic party retaining full control following the midterm elections is quite low, thereby setting the stage for a divided government.

The Congressional landscape

The US Senate is currently split 50/50 with Democratic Vice President Kamala Harris providing the tie-breaking vote on issues requiring a simple majority. However, in this midterm cycle there are 35 Senate seats up for election, of which 21 are currently held by Republicans and 14 held by Democrats. Among these 35 races, eight are particularly tight and four of those seats are currently held by Democrats. Should the Republican party flip just one of those seats, and assuming they maintain their incumbents, they will be able to take control of the Senate. That notwithstanding, Senate races in this cycle have been highly competitive making a shift in the balance of power within that chamber extremely difficult to predict.

In the House of Representatives all 435 seats are up for election with the Democratic party currently enjoying a five-seat majority. That said, midterm election years have typically resulted in large swings across the political landscape. The party of the President has lost House seats in 17 of 19 midterm elections since World War II. Retention in the Senate for the President's party has been nearly as challenging with seats lost in 13 of those 19 midterm elections.

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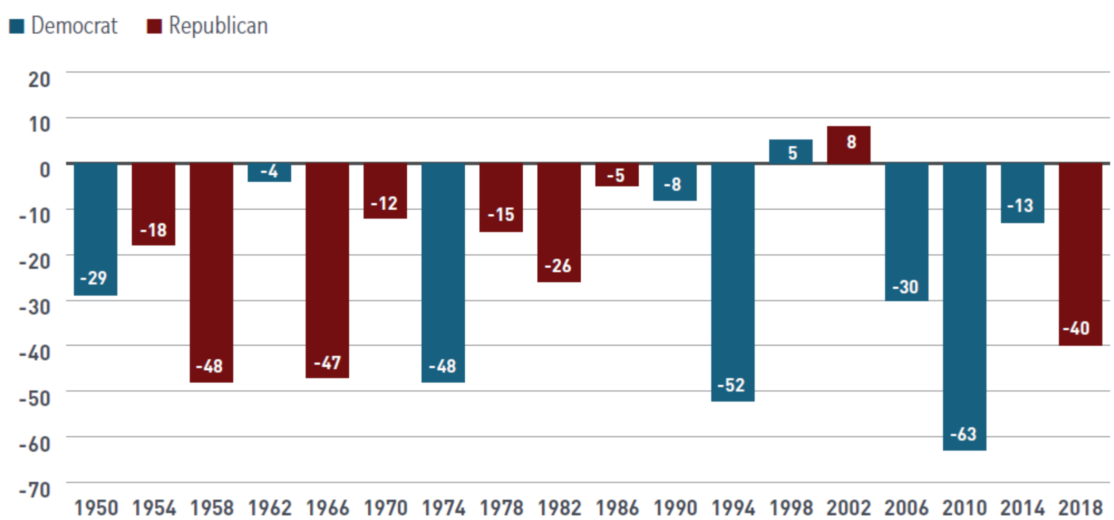
Moreover, midterms are commonly viewed by the electorate as a referendum on a new administration and the state of the economy. On this front, the Biden administration continues to struggle under the weight of decades high inflation, a dramatic sell-off across the financial markets, and the growing specter of recession. The confluence of history, market, and economic conditions paint a challenging picture for Democrats, and in contrast creates an environment that should favor Republicans. The following chart shows the net change in House seats in midterm elections since 1950 and illustrates the statistical headwind facing the Democratic party.



Source: The Presidency Project at UC Santa Barbara.
Source document : MFS Midterm Elections Preview

Midterms by the numbers

Midterm election years have consistently demonstrated elevated levels of volatility and experienced outsized intra-year drawdowns. History has shown financial market returns to be at their weakest during the second year of a presidential term. Market analysis conducted by Ned Davis Research Inc. indicates that since 1948 the median annualized returns for the S&P 500 during presidential terms were 12.9% in year one, 6.2% in year two, 16.7% in year three, and 7.3% in year four. Additionally, the years with midterms have tended to see gains backloaded until after the elections. One explanation is that the uncertainty preceding midterm elections may be a factor. As financial markets abhor ambiguity, it stands to reason that market gains are held back until election results are known and the political landscape is established. Alternatively, another explanation is that presidential administrations very often adopt stimulative policies ahead of reelection campaigns, benefitting the financial markets as a consequence. Nevertheless, the chart below clearly depicts the binary nature of market returns over pre and post midterm election periods.

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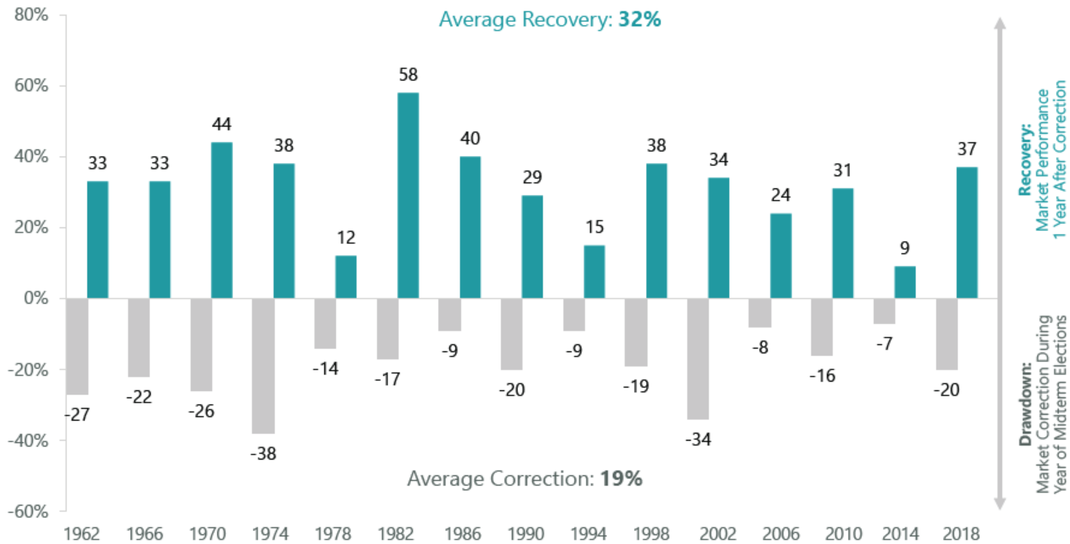

Source: Source: Standard & Poor's, Bloomberg. Past performance is not a guarantee of future results. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.
Source document : Clear Bridge Anatomy of Recession

And if there's gridlock?

If the midterms unfold as history suggests, then we are likely to have some form of divided government following the elections. While Washington gridlock may prove challenging for voters and policymakers, investors have tended to welcome it. History has shown that the best periods of return often occur when one party controls the White House and the other party controls at least one chamber of Congress. Political gridlock would likely improve the fiscal outlook as government spending, and government borrowing by extension, have historically stalled or fallen during these conditions. From an economic standpoint, less spending and less borrowing should lead to lower deficits, which is positive for federal finances and rebuilds the supportive capabilities of the federal government. As the following chart exhibits, average 1-year returns of the S&P 500 under a split Congress is clearly superior to the same returns under both Democratic and Republican controlled Congresses.

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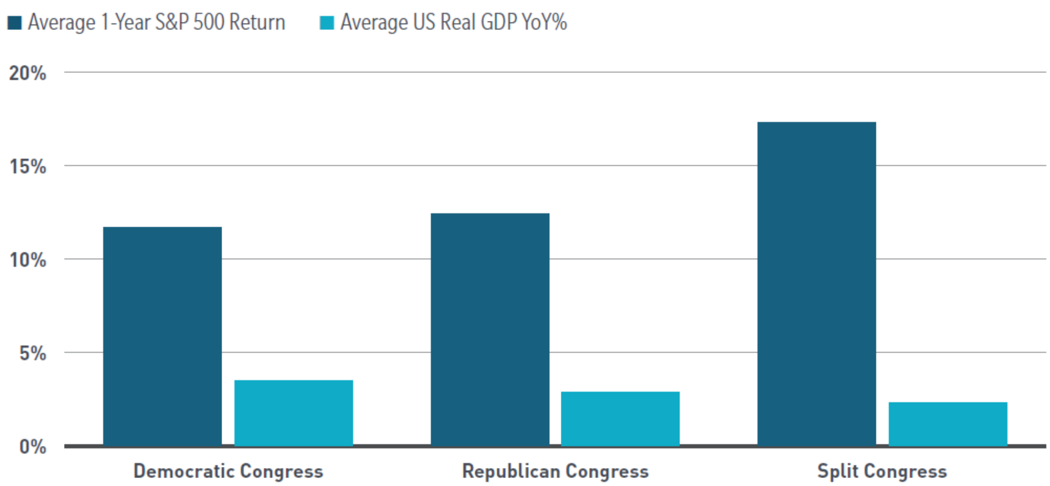

Source: FactSet, FactSet SPAR, History, Art & Archives: United States House of Representatives (https://history.house.gov/Institution/Presidents-Coinciding/Party-Government/). Quarterly data from 31 December 1949 to 30 September 2021 (latest available). Split Congress is defined as Senate being majority Democratic and House of Representatives being majority Republican and vice versa. Averages are calculated based on each category, using 1-year rolling S&P 500 returns and year-over-year changes in US Real GDP. S&P 500 Return is gross and in USD. Source document: MFS Midterm Elections Preview

What's an investor to do

While the market uncertainty preceding midterm elections is uncomfortable, history suggests that we are likely to see some form of a divided government following the elections, and as a result experience political gridlock over the next two years. History also suggests that investment returns recover sharply in the period after the elections as the markets tend to follow a similar pattern – falling in the months preceding the midterms and then rallying thereafter. As such, investors have historically been rewarded for weathering the weakness of midterm election years with robust returns in the period following.

Undoubtedly, the political stakes are high given the divisive state of US politics. However, the divided government that is likely to result from this year's midterms should be beneficial for the financial markets. As such, investors are best served to look beyond the noise and uncertainty heading into the elections and rather focus on the fiscal and policy actions (or lack thereof) that should result under a split Congress. History has shown the financial markets to be quite resilient in the periods following elections. Remaining invested and staying the course are prudent actions to take as a divided government may very well prove to be a tailwind for the financial markets.

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