What's at Stake in the Midterm Elections?

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In a word, **plenty**. The November 6 elections will contest all 435 seats in the House of Representatives, 35 of the 100 seats in the Senate (including two special elections in Mississippi and Minnesota), 36 state governorships and many state legislative seats.[1] The outlook for fiscal policy, the economy, markets, and possibly President Trump's re-election hopes could hinge on whether the congressional races result in the status quo, a split Congress or a Democrat sweep.[2]

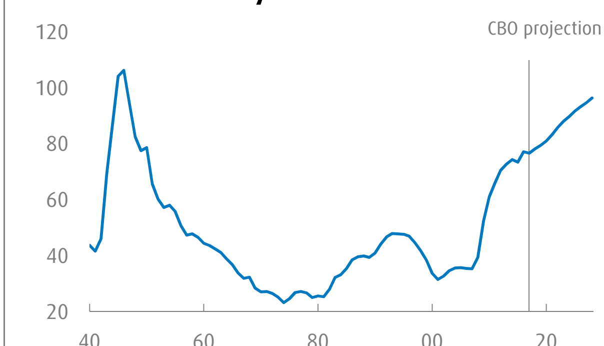
According to recent polls, the likeliest outcome is a split Congress with Democrats controlling the House. The Democrats need to pick up 2 seats in the Senate to gain a majority, but this could prove daunting as they need to hold on to 26 of the contested districts, ten of which are in states won by Trump in 2016. In the House, the Democrats need to retain their seats, plus flip 23 of the 236 Republican-held districts. Prediction markets are wagering they will succeed in taking the House though not the Senate.

A **divided Congress** would shift the balance of political power, reducing the GOP's ability to pass legislation without relying on Democrat support. Even with a current slight majority in the Senate, the Republicans need bipartisan support to overcome the 60-vote filibuster rule for advancing most bills.[3] A Democrat-led House would likely oppose most new legislation proposed by the Republicans and backed by the President, delaying or even derailing their agenda. Trump's deregulation push would face staunch opposition. The prospects for another tax-cut program, including an extension of the personal tax cuts that expire after 2025, would decline, while the chances of a government shutdown over funding issues would increase. Policy gridlock and uncertainty could depress business confidence and dampen the expansion. If an economic issue were to arise that required a quick policy response, the probability of the response passing on the Hill would decrease.

A divided Congress, however, could result in **more fiscal stimulus** skewed toward infrastructure spending, which the President has championed. The trade-off is more **federal debt**, which the Congressional Budget Office already sees headed toward 100% of GDP in a decade from 78% currently (*Chart 1*). This would reduce the government's flexibility to cushion the next downturn, while risking another credit-rating downgrade.

Controlling the House would position the Democrats to gain sway over committee priorities and investigate allegations about the administration (e.g., the Russia probe). They would gain subpoena power to access documents (like tax returns) and compel witnesses to testify before House panels. The House would be more apt to push for **impeachment** with a simple majority vote required to send

Chart 1
Debt Defying
United States (% of GDP)
Federal Debt Held by the Public



Sources: BMO Economics, Haver Analytics

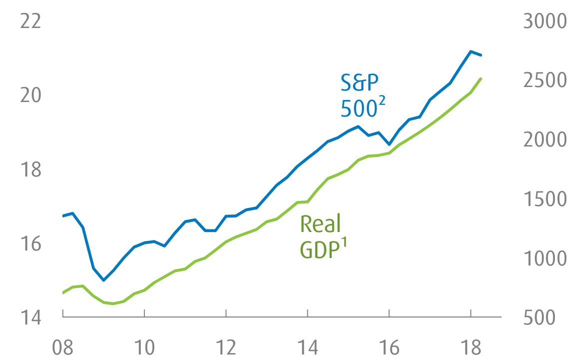
[1] Since congressional legislation has the most influence on the national economy, our note focuses on this race rather than the gubernatorial and state elections.

[2] A special thanks to Greg Anderson, BMO's Global Head of FX Strategy, for insightful comments on this note.

[3] Apart from using the special reconciliation process for some bills that requires a simple majority vote to pass into law, as per the tax reform bill earlier this year.

proceedings to the Senate. Here, a two-thirds vote is required to remove a president from office, implying the likely need for substantial Republican support.[4] Either way, a more combative political backdrop could **rattle investors**.

Chart 2
Bulls With Legs
United States



¹ (lhs : chained US$ trlns) ² (rhs : 1941-43 = 100)
Sources: BMO Economics, Haver Analytics

Should the Republicans retain control of Congress, the second likeliest outcome, they would likely take another stab at repealing the Affordable Care Act (which fell one vote short of passage in the Senate last year). The GOP could also seek to **reform welfare and entitlement programs** (Medicare and Social Security), though Trump has opposed the latter. It would eye Tax Reform 2.0 and more deregulation, a market-friendly combo that could improve the President's 2020 prospects by extending the current long-running expansions of the economy and stock market (*Chart 2*).[5]

In the less likely event that Democrats sweep Congress, the push for further tax cuts and deregulations would come to a halt. Controlling the Senate would allow them to block the President's Supreme Court nominees from confirmation. They could also block the appointment of other senior officials, thereby leaving a void should current officials leave or get fired. However, even if the Democrats win a sizeable majority in the Senate, they are unlikely to pass legislation that reflects their priorities (e.g., more stringent climate-control measures, Medicare expansion, immigration support) given the President's veto power, which can only be overridden by a two-thirds vote in both chambers.

Midterm elections are normally viewed as a referendum on the sitting President, and this one probably more than others. A Democratic sweep could **reduce Trump's re-election chances**, notably if they stonewall his agenda and turn him into a lame-duck (as hard as that is to imagine). This would have far-reaching implications for trade and foreign policies beyond 2020.

Unclear is whether a Democrat-led Congress would rebel against Trump's tariffs and forestall a full-blown **trade war**. Traditionally, Democrats have tended to be the more protectionist party, though the roles have shifted. As well, the new Congress will need to review and approve a **NAFTA** deal, assuming there is one, and it's unclear whether the Democrats will give it their blessing.

Bottom Line: If the Democrats regain control of Congress, they could derail further action on tax cuts and deregulations, while pushing for more government spending and possible impeachment. Resulting policy gridlock could unsettle equities while supporting Treasuries, at least temporarily. By contrast, if the Republicans retain control, an extension of current business-friendly policies could support corporate profits and equities, at the risk of pushing interest rates and the dollar higher.

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[4] The impeachment process starts in the House if a majority of members believe the President has committed "treason, bribery, or other high crimes and misdemeanors." The Senate then acts as judge and jury in the proceedings and a two-thirds vote is required to convict and recommend removal from office. No President has been impeached in the Senate, though Nixon resigned before it could vote. Andrew Johnson and Bill Clinton were recommended for impeachment by the House but were not convicted in the Senate (Johnson came within a single vote).

[5] One piece of trivia, the S&P 500 has never declined in the 12-month period following a midterm election going back to 1950.