U.S. Midterm Elections: Purple Haze

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When you mix blue and red, you get purple, be it paint or political parties. The Democrats gained control of the House of Representatives in this week's midterm elections, wresting at least 32 districts (as of November 8, and possibly as many as 44 when the dust settles) away from the Republicans, particularly in suburban areas and among independents (*Table 1*). However, the Republicans retained control of the Senate, snatching at least one seat (and as many as three) from the Democrats. Both sides (and the President) are declaring victory.

A divided Congress (starting January 3) **creates more political and policy uncertainty** than the status quo. Potential new House committee chairs have already indicated a desire for more oversight of the Administration and more ardent investigation of allegations. There's talk of subpoenaing President Trump's tax returns, and we are still awaiting Robert Mueller's report on Russia's possible meddling in the 2016 election. The ousting of Attorney General Sessions, a day after the election, clearly increases the risk of an ugly confrontation with the White House. To the extent this uncertainty undermines business confidence, the economy could slow. However, with sentiment already at multi-decade highs, the impact should be contained. Echoing this view, U.S. equities are back on firmer ground, rallying the most (just over 2%) the day after the midterms since 1982.

A split Congress also **raises the risk of a government shutdown or debt ceiling deadlock**, notably if the President doesn't receive funding for his border wall. A continuing resolution is currently funding part of federal spending until December 7, with the remainder in place until the end of the fiscal year (September 30, 2019). The debt ceiling has been suspended until March 1, 2019, when it will reset at the actual debt level on that day. Unless the ceiling is lifted, the Treasury will need to invoke "extraordinary measures" to keep the government funded for a while longer. If the ceiling is not subsequently raised, the country could default on its payments, drawing a credit-rating downgrade that would unsettle markets.

By controlling the House legislative agenda, the **Democrats can resist further tax cuts**. This includes making the current personal tax reductions that expire at the end of 2025 permanent, and nixing the President's recent proposal for a 10% middle-class tax cut. The House will likely resist a further rollback of Obamacare, particularly with pre-existing conditions such a hot topic. The Democrats may attempt to expand health-care coverage, though the bill would likely die on the Senate floor or be vetoed by the President. They and the President could work together to rein in prescription drug prices. The House Democrats might try to raise the federal minimum wage (currently at $7.25, though higher in more than half of the states), which is also unlikely to be passed in the Senate. Meantime, the GOP's aim to reform entitlement programs will face strong opposition.

Further deregulation efforts might not as easily pass congressional muster, which would be less constructive for the economic outlook. The Democrats will lead House oversight

Table 1
Election Results

U.S. Congress (as of November 9, 11:30 am)

	Current	Election	Change
Senate	35 of 100 seats contested; 2 not yet called 51 needed for majority		
Republicans	51 (9)	52 (10)	+1
Democrats[1]	49 (26)	46 (23)	-3
House of Representatives	all 435 seats contested; 12 not yet called 218 needed for majority		
Republicans	235	198	-37
Democrats	193	225	+32
Vacant	7	—	

[1] includes independents caucusing with Democrats
( ) = contested Senate seats
Sources: BMO Economics, RealClearPolitics

committees, delaying or derailing new deregulation measures. The expected appointment of Maxine Waters, a staunch critic of banks, to lead the House Financial Services Committee (the overseer of the financial sector) could slow the deregulation train, while drawing increased scrutiny of Wall Street and regulators. She will have authority to subpoena documents and compel bank executives and agency officials to testify to Congress.

While the House is now positioned to block bills on new regulations, **the Democrats likely can't prevent a further easing of the financial rules**. Congress has already given many agencies, including the Fed, wide authority to rewrite guidelines based on past legislation. The trajectory of rule changes related to trading restrictions, stress tests and capital requirements likely won't shift much. If the Democrats find some bipartisan support, they might have better luck on environmental issues, such as preventing a further weakening of the Environmental Protection Agency.

The **Democrats will push for more infrastructure spending** (apart from a border wall, of course), as suggested by Nancy Pelosi's acceptance speech on behalf of her party. There is common ground here with the President, though less so with his party. Keep in mind that a dollar increase in spending is likely more stimulative than a dollar decrease in taxes, at least in the near term.

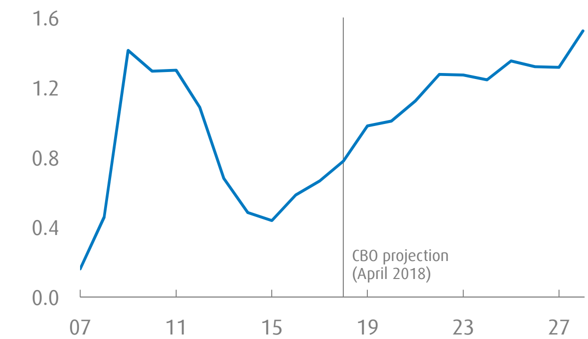
Still, there are **two reasons why more stimulative fiscal policy is not in the cards**. First, a **divided Congress could result in policy gridlock**, with one chamber unwilling to sanction the other's tax and spending proposals. In fact, if the discretionary spending caps that were raised in the 2018 Budget are not extended in fiscal 2020, the economy could face a fiscal hit of 0.5%.

Second, there's the elephant in the room. The **return of trillion dollar budget deficits** (*Chart 1*) will have a constraining effect on lawmakers. The deficit will weigh in at almost 5% of GDP next year (*Chart 2*), a record for non-recession periods. Indeed, since the mid-1950s, there have been only five years in which the deficit-to-GDP ratio was above 5%—four times during or just after the Great Recession and once in the early-1980s' recession. The Congressional Budget Office (CBO) asserts that the run-up in debt outstanding (*Chart 3*) will have *"serious negative consequences for the budget and the nation."* The debt will crimp fiscal capacity to counter the next downturn, result in interest payments consuming a greater share of revenue, and risk triggering a "*fiscal crisis*" (perhaps sparked by a downgrade of America's credit rating). No doubt, the deficit will become a big issue in the 2020 election. Still, a split Congress might **not materially alter the deficit path**, with the reduced prospect of further tax cuts offset by a greater chance of increased infrastructure spending and less cost savings from entitlement reforms.

Chart 1
Elephant in the Room

United States ($trlns, fiscal years)

Federal Budget Deficit

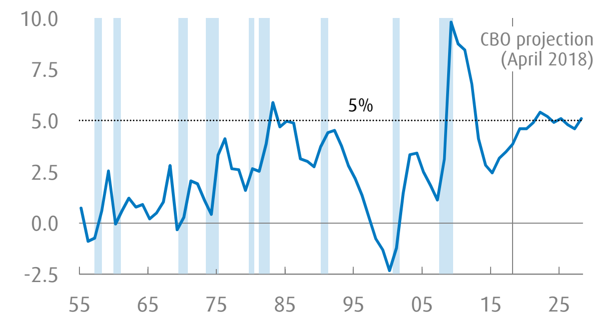


Source: BMO Economics

Chart 2
Thin Cushion

United States (% of GDP[1], fiscal years)

Federal Budget Deficit

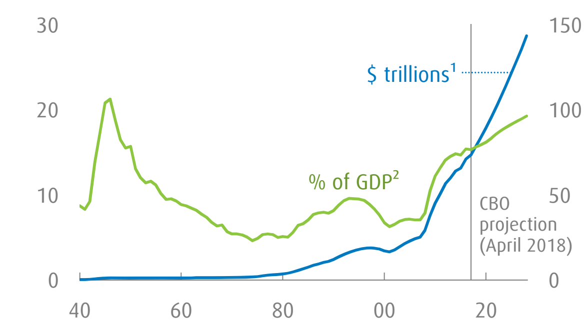


Shading marks periods of U.S. recession
Source: BMO Economics   [1] 2018 = BMO Economics estimate

Chart 3
CBO: "Serious Negative Consequences"

United States (fiscal years)

Debt Held by the Public



[1] (lhs) [2] (rhs)
Source: BMO Economics

On the trade front, a **split Congress means more uncertainty about the USMCA's passage given the need for House support and the possibility that the Democrats will demand concessions to ratify the deal.** Though likely to garner much drama, we believe the USMCA will be ratified in the new Congress given general support among American businesses. (There's an outside chance it could get approved before the new Congress begins.) As well, the Democrats have probably become more pro-trade compared to the original NAFTA days, even as the Republican base has become less so. Recall that the original NAFTA was signed by the leaders of Canada, the U.S. and Mexico in December 1992, but it required modification in the form of two side deals on labour and environmental issues before Congress passed it in November 1993. (The Democrats held on to their majorities in both the House and Senate after the 1992 election.) This time, the Democrats might try to amend the deal to address the same two issues. Under "fast track" trade legislation passed in 2015, the House and Senate will vote all-or-nothing on the USMCA, with no amendments allowed. If the House introduces a bill to repeal this legislation, the odds of passage would decline.

It's **not clear whether a Democrat-led House will help or hinder a resolution of the current trade imbroglio with China**. The President seems dead set in getting China to change its trade policies, and he has considerable power to impose tariffs without congressional approval (barring a 60-vote majority in the Senate). A 10% tariff on $250 billion of China's goods is due to rise to 25% on January 1 (matching that on the earlier $50 billion), and the President has threatened to impose a duty on the rest of its shipments (about $285 billion) if upcoming talks fail to make progress. Congress could weigh in on trade deals that the Administration will begin to negotiate with the EU and Japan early next year, and with the U.K. post-Brexit.

While the above uncertainties could modestly dampen confidence and GDP, and clearly imply some downside risk to the outlook, **the new political landscape should not materially harm the economy**. We still see growth moderating from 2.9% this year to 2.5% in 2019 and to 1.7% in 2020 in response to fading fiscal stimulus and rising interest rates. The Fed should still lift policy rates five more times before mid-2020, though the risk of doing less has increased. The **greenback was already expected to soften** next year amid slower growth, and the political drama will only encourage this trend.

Bottom Line: The midterm elections have not changed our outlook for the economy, Fed policy or the budget deficit, but will result in increased volatility for markets as newly empowered Democrats lock horns with the Administration ahead of the 2020 presidential election.