US MID-TERM ELECTIONS: A BRIEF GUIDE TO THE THREE DIFFERENT POSSIBLE NOTES OF BLUE

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The US mid-term elections will take place today (Tuesday 6 November). They may carry large implications, not only for US policy going forward, but also for equities markets, US rates and the greenback. In this briefing note, we will examine the possible outcomes and their probable implications on financial markets.

Setting the scene

American citizens will renew their legislators (435 seats in the House of Representatives) and select a large portion of senators (35 of the 100 seats in the Senate). In addition, 39 state and territorial governorships will be contested and other state and local elections will also be held. These mid-term elections could be seen as an appraisal of the first two years of the Donald Trump presidency. Does the "America First" policy still resonate with the electorate, especially in the light of potential collateral damages for some economic agents? Have legal issues started to overcome the overall economic benefits enjoyed so far? The outcome of the mid-term elections will have major impact and ramifications for economic and trade policy for the next two years and beyond as it will give the first insight into the 2020 presidential election.

The GOP (the Grand Old Party or the Republican party) currently holds the Presidency and the majorities in both the House and the Senate, but they may lose control of one or both chambers. The Democrats need to flip at least 24 seats in the House (out of a total of 435) or grab a minimum of two additional seats in the Senate (out of a total of 100) to regain control of at least one chamber.

What are the scenarios and their odds?

According to recent polls, the most likely scenario is a Blue House, where Democrats win the House, while Republicans retain control of the Senate (roughly 50% probability). The two other possible outcomes, a "Blue Sweep", whereby both the House and Senate fall to Democrat hands, or a "Red Wall", where Republicans keep both the Senate and House majority, have approximatively the same probability of about 25% each.

Implications for markets

In this section, we review the possible impact on economic and trade policy as well as the market implications of these three possible outcomes.

Blue House/Red Senate

As it is the most probable and thus the expected outcome, but also because it is the least extreme one, we should observe a relief rally for equities. This scenario would remove some uncertainties linked to the two other less expected outcomes.

US rates may trend somewhat lower in the first few days following the elections as Trump's policies may be put into question. However, the trend over the next few months will depend on the margin of the Democrats' victory in the House and in which states Democrats win back some governorships (a large swing in agricultural or industrial states will likely soften Trump's tone in trade or immigration policies). These factors will determine the "real" balance of power between the House and President Trump. The same could be said for the dollar's trend or equity market direction over the next few months. Other than an equity relief rally and a somewhat softer US dollar in the first few hours or days following the results, the markets will need some time to digest and understand this new balance of power and what could be the nuances of this outcome compared to the two most extreme cases discussed here below.

Blue Sweep

While this outcome may appear at first glance as the most negative for equities (especially in the very short term and especially for US equities and some specific sectors), we consider it to be overall neutral as far as global equity markets are concerned. US earnings growth will certainly need to be adjusted lower due to less budget and fiscal support, but, on the plus side of the equation, it implies also easier financial conditions (lower US rates and a softer greenback down the road).

A Blue Sweep likely eliminates indeed the possibility of a Tax 2.0 plan in the immediate future and US Treasury investors should thus perceive some fiscal contraction, or at least some discipline, going forward. As a result, it should be positive for US Treasuries (as this outcome means potentially less growth, less deficit, less inflationary pressures and a less hawkish scenario than in a Red Wall case).

Risks may arise later if the President and Democrats then work together to pass an infrastructure bill and/or increase spending. However, it will take some time and it should not be as bold and easy to go through a gridlocked Washington DC compared to a Red Wall. Democrats may want to wait as they have no strong incentive to pursue an infrastructure plan before their 2020 campaign.

Markets may also price in some de-escalation of trade tensions with China. Along with a possible weaker USD and/or a less hawkish Fed in the near future, it could lead to a catch-

up for EM assets (equities, bonds and forex). However, we believe that the trade outcome is more or less the same under all electoral scenarios as both parties believe it's necessary to challenge China on its mercantilism policies. In the medium term, there is even a risk than Trump will spend more time on international policies as he will not have a strong enough backing on domestic policies. In other words, the President and Congress will only reverse or soften the tone on trade war when they will be forced to by a politically unbearable market reaction or economic slowdown.

Some key sectors such as Telecom, Pharma and Healthcare Services may be under pressure on the evidence that electors are willing to embrace more progressive policies such as the reintroduction of regulations (Telecom), a push for drug price controls (Pharma) and an expanded government role in healthcare services.

Red Wall

Tax cut 2.0 will likely be implemented, which will be seen as a positive catalyst to renew US growth and thus US equities earnings. As a result, it should imply further Fed monetary policy tightening in 2019 than currently priced in by markets which would support the dollar in the foreseeable future. It would also increase the risk of a sharp depreciation of the US dollar going forward due to growing (and somewhat uncontrolled) budget deficit, especially as soon as growth starts to moderate and/or the Fed ends its tightening cycle.

In this scenario, an upward trend in US long rates will likely resume (probably above 3.5% in

the next few months), which poses a risk for US equities and USD corporate bonds whose current valuations are stretched. Therefore, the resulting outcome for US equities in the medium term is a difficult balancing act between, on one hand, support coming from upward earnings revisions, and on the other hand, a potential drag from rising rates on valuations. More volatility should be expected down the road.

Non-US assets are expected to continue to suffer from Trump's "Make America Great Again" (at the expense of others) policy. EM and to a lesser extent other DM equities should underperform US equities, especially if USD and US rates resume their upward trends.

Conclusions

US mid-terms elections will have large implications and ramifications for US policy and financial markets. While we expect a muted positive reaction for equities in the most likely outcome (Blue House/Red Senate), it will take some time for markets to integrate this, to gauge the balance of power and to assess who will really be in charge for the next two years. The medium term market reaction will then look like a nuance between the two other fat-tail scenarios (~25% probability for each) where Trump either has more manoeuvring room to pursue his current politics or has to "think at least twice" before committing to anything.

These two outlier scenarios would certainly be more volatile outcomes for financial markets, accelerating or completely reversing some big trends we have seen on equities, currencies and rates over the previous months.

Financial Assets	Blue House/Red Senate	Blue Sweep	Red Wall
US equities	Mildly bullish first reaction/ Neutral overall but depends on the "quality and quantity" of Democrats power in the House	Mildly bearish first reaction/ Neutral overall but with some sector losers	Mildly bullish first reaction/ Neutral overall but with high volatility and some sector dispersion (losers in the supply chain/ winners in infrastructure)
US rates	Mildly bullish (rates decline, Treasury prices move higher)	Bullish	Bearish
USD	Mildly bearish	Bearish	Bullish in the foreseeable future/increased risk of a sharp depreciation beyond
Global equities	Mildly bullish	Mildly bullish with relative outperformance compared to US	Neutral with relative underperformance compared to US
EM assets	Mildly bullish	Mildly bullish with relative outperformance compared to DM	Mildly bearish with relative underperformance compared to DM