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2018 elections recap: What does this mean for investors?

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KEY POINTS:

- From an economic and markets perspective, the election results probably matter less than many think. Rising federal debt and deficit levels will limit Washington's ability to accomplish much over the next two years.
- Trade issues remain a significant risk and rising protectionism is a threat to the global economy. Investors should watch this issue carefully.
- The election results do not change our overall "risk-on" stance. We think equity markets and fixed income credit sectors continue to look relatively attractive.

Elections do matter to investors.
But they matter less than many think.

The months of campaigning are finally over and voters have cast their ballots. While a few races around the country are still too close to call, Democrats added enough seats to take over the House of Representatives, while Republicans held their lead in the Senate. As the results came in, pundits focused on who was winning and why, and what it may mean for potential legislative changes.

But investors ask another important question: What will these results mean for the markets? In the following pages, we discuss some key ideas investors should consider and offer our thoughts on the election results might mean.

The economic effects of the election probably won't be significant. ***But the political effects may be.***

WHAT HAPPENED? DOES THIS ELECTION MATTER?

The Democrats winning the House and Republicans keeping the Senate was the most expected outcome by pundits, betting markets and investors alike. As a result, this outcome had essentially been priced in to financial markets. The 2018 election was not a "wave election." In 2008, Democrats won the White House and made massive gains in both houses of Congress. In the 2010 midterms, Republicans took over the House and picked up several Senate seats. Even 2016 was a "wave" as Donald Trump won a surprising presidential victory. Rather, the fact that Democrats now control one house of Congress does represent a shift in the balance of power, but it is a modest shift. From an economic and markets perspective, these election results do matter, but they probably matter less than previous elections.

There is a critical point to be made about the current political environment, the economy and financial markets: Investors who voted for Donald Trump hoping for a pro-growth agenda were essentially looking for a tax cut and less regulation. The 2017 tax cuts are a done deal. Democrats in the House will probably try to vote on a modification or repeal, but that will be largely for show. The president would certainly veto any changes to what he views as his signature legislative accomplishment. Likewise, reducing regulations is well underway and remain the purview of the executive branch. From a fundamental perspective, federal policy appears to remain firmly in a pro-growth mode for the next two years.

The political perspective will likely reflect the biggest implications of this power shift. A Democratic House probably means we'll see congressional investigations of and hearings about the Trump administration. And based on the outcome of the Robert Mueller investigation, we could see a move toward impeachment (although it's nearly impossible to imagine the Senate removing President Trump from office). All of these events are likely to create additional political noise, which could raise risk premiums for financial assets and add to market volatility. But they are unlikely to affect economic or market fundamentals.

EXPECT INCREASED POLITICAL DISCORD

With a divided government, we expect a clogged legislative pipeline and an even more dysfunctional budgeting process. We could face government shutdowns, brinksmanship

over the debt ceiling and, of course, more contentious legislative oversight of the executive branch. These events are likely to disturb financial markets if and when investors focus on the headlines, but we don't think they will meaningfully detract from economic growth or investor confidence.

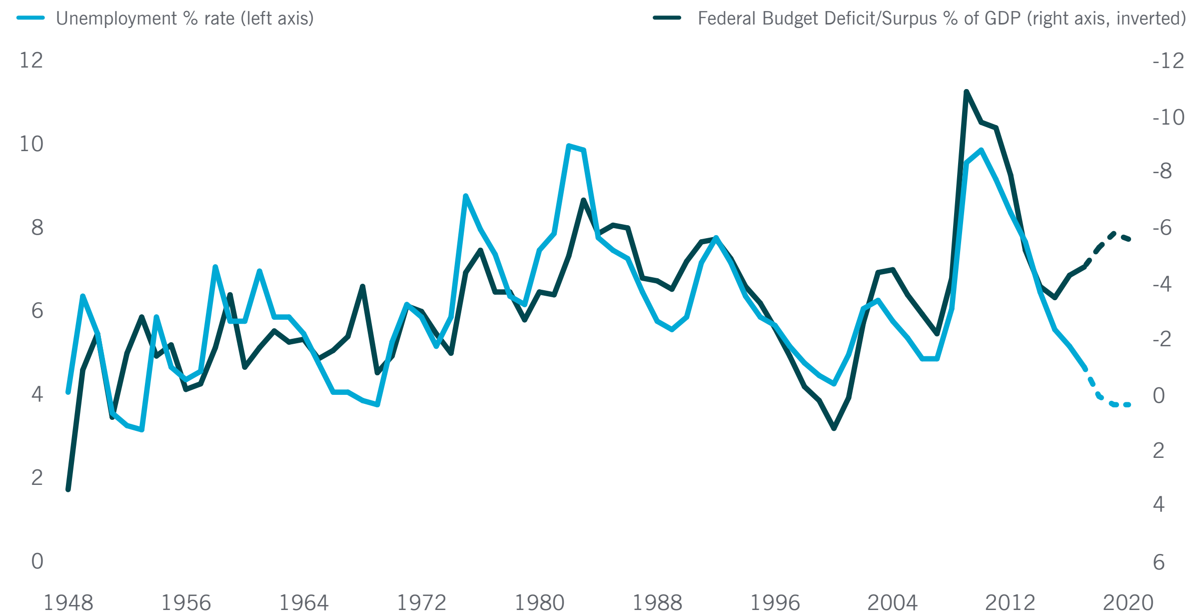
A divided government also means we will likely see even more policymaking through executive action compared to the first two years of the Trump administration. We expect more executive orders and action on everything from trade policy, immigration and regulations. These could further raise the risks of political instability.

There is a chance, however, that President Trump could find a way to work with Democrats in Congress. He has never faced an opposition party in power, and it is tough to predict how Donald Trump will react. The president is not a strict ideologue about most issues. Above all, he appears to be motivated to gain political "wins." We could see agreement on issues like raising the minimum wage slightly or addressing prescription drug pricing—broadly popular issues that Democrats will likely push for.

ADDITIONAL SPENDING OR MORE TAX CUTS ARE UNLIKELY

Regardless of the makeup of Congress, the United States is facing growing debts and deficits. There appears to be no political appetite on either side of the aisle to address these issues. The U.S. is in the midst of an almost unprecedented experiment: The Federal Reserve is tightening monetary policy while tax cuts and increased spending are loosening fiscal policy. As a percentage of U.S. gross domestic product, the federal government is running widening deficits. This is remarkable in the tenth year of an economic expansion with the unemployment rate remaining below 4%.

An unusual divergence: The deficit is growing while unemployment is falling



Source: Bloomberg, L.P. Annual readings from 1948-2020. 2018-2020 are estimates.

The net effect of this trend is that the government is running out of money to spend on major new initiatives or significant new tax cuts. The makeup of the government aside, the size of the federal deficit limits the scope for new legislation over the next two years.

Interestingly, investors and financial markets don't yet seem bothered by rising debts and deficits. Absent a tipping point like the onset of a recession, we don't think that will change. As a result, we anticipate the budget situation will remain status quo for the next couple of years.

IS THERE A RISK OF ECONOMIC OVERHEATING?

We see almost no chance of repealing tax cuts or reigning in spending. And we see little scope for new legislation based on political gridlock and lack of funds. Any changes to policy around the margins, however, would probably involve new spending programs or tweaks to the tax code.

To us, this suggests we could see a risk of economic overheating in the next two years. An overheating economy is certainly a bigger risk than a near-term recession. Any additional economic stimulus could create risks that the Fed would become more aggressive. This could lead to a more pronounced spike in interest rates and downward pressure on equity markets.

WATCH THESE ISSUES OVER THE NEXT TWO YEARS

Although we do not expect significant market-moving legislation over the next two years, some important issues bear watching:

- **Trade:** Trade issues will undoubtedly have major influence from an economic and financial markets perspective. It takes times for the actual economic effects of trade tensions to be felt, and it is difficult to gauge the actual impact. But as an example, we would estimate that a 25% tax rate on imported Chinese goods would equal a 0.2% to 0.4% drag on 2019 U.S. GDP, depending on possible Chinese retaliation and corporate sector reaction (e.g., less hiring, lower capital investment or an equity market pullback). Should trade issues escalate further – perhaps the U.S. enacts tariffs on European automobiles, for example – that could exacerbate the issue and cause a 0.5% growth drag.

  Gaming out exactly how trade issues will progress is very difficult. Optimistically, President Trump may continue to use aggressive rhetoric while avoiding an outright trade war and reach a deal with China. Downside risk clearly exists around trade.

- **Tax policy:** Democrats in Congress are likely to angle for a repeal or scale back of the 2017 tax bill, but the president's veto ability makes these changes a non-starter. We could see additional tax reform around such issues as a minimum wage increase or indexing capital gains, but any additional tax policy changes over the next two years should be relatively minor.

- **Infrastructure spending:** President Trump and Democrats may agree somewhat on this issue. We could see a minor spending deal or a plan that kicks spending down the road, but the country's fiscal situation makes it hard to envision anything significant.

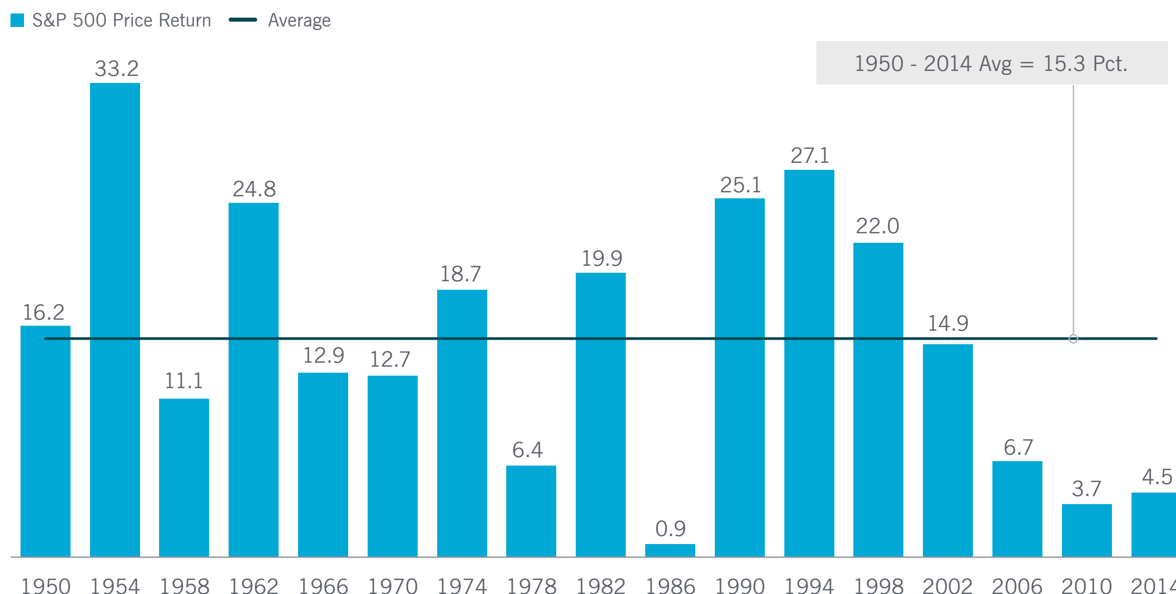
- **Other issues:** Other important items such as healthcare legislation, financial regulation, energy policy and immigration laws will likely remain at the forefront of political discussions. While these issues may affect the economy and markets, we don't expect much to happen.

REMOVAL OF UNCERTAINTY COULD BE GOOD FOR STOCKS AND OTHER RISK ASSETS

Investors loathe uncertainty, and heightened volatility and market declines are not uncommon in advance of elections. But risk assets have historically performed relatively well in the aftermath of elections. For instance, since 1950, the stock market has not declined in any 12-month period following a midterm election. And the average gain for stocks has been 15.3%.

Stocks have historically made gains following elections:

S&P 500 Index price return in the 12 months following midterms



Source: Strategas Research Partners LLC. Data shows the 12-month price return of the S&P 500 Index following midterm elections since 1950. **Past performance is no guarantee of future results.** Different indexes and economic periods will produce different results. Indexes are unmanaged and unavailable for direct investment.

It's impossible to explain this trend with any degree of certainty. Perhaps as presidents approach reelection or start to consider their legacy, they focus on the economy and try to enact policies that promote growth, which are usually friendly to equity markets. Should 2019 follow this pattern, it could mean another tailwind for equities.

LOOKING AHEAD TO 2020: WILL A RECESSION AFFECT THE OUTCOME?

The dust has barely settled, and already politicians and prognosticators are eyeing the next set of elections in two years. Two years is an eternity in politics and it is little more than background noise to speculate about who will run for president (much less who will win).

One issue we do think will be important is the timing of the next recession. Most observers (ourselves included) do not see signs of a recession before 2020 at the earliest. Today, financial markets are not pricing in recession risks, but that could change before the next election. If growth does slow, or if worries about slowing growth become more pronounced, that would probably create a more difficult environment for Republicans in the next election.

In any case, we anticipate that the 2020 election will be significant in terms of potential policy shifts. Should Democrats win the presidency, there is a strong chance that they would take a run at single-payer healthcare and try to restructure the tax code, as two examples. And if Republicans retain the White House, we would probably see an effort to remove the sunset provisions of the 2017 tax law.

The one thing we know for sure: we can expect only a brief respite before the campaign commercials start up again.

For more information, please visit us at nuveen.com.

Glossery

The **S&P 500 Index** is a capitalization-weighted index of 500 stocks designed to measure the performance of the broad domestic economy.

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