NOVEMBER 2022 CLIENT QUESTION
POST MIDTERM ELECTION UPDATE

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More than ten days after the midterm elections we finally have a sense of the makeup of government over the next two years. According to the Associated Press, Democrats retained the House with at least a 50-50 split while Republicans captured the House with 218 seats required for a majority.

The final makeup of the Senate will be determined by a runoff vote in Georgia on December 6th, but Democrats will have control no matter the outcome as Vice President Harris serves as the tiebreaking vote in a 50-50 standoff. There are still several races left to be called in the House, but Republicans have already gained at least the nine seats necessary to secure control.

Implications of Divided Government

A divided government will impact future nominations and legislation.

Presidential nominees are confirmed in the Senate through a simple majority. The biggest impact to the economy and markets from Democrats retaining the Senate will be on regulations. Democrats will have an easier time confirming nominees who favor stronger regulations.

Legislation is of course more difficult under divided government as it will require bipartisan support. Republicans taking the House likely decreases the chances of passing any major tax hikes, entitlement reform, or government spending packages. Key features of the 2017 Tax Cuts and Jobs Act, including lower individual tax rates, are set to lapse in 2025, with Republicans favoring extension while Democrats would prefer letting them expire. Congress may not be able to reach an agreement over the next two years, but the issue will likely become a focal point of the 2024 elections.

Congressman Kevin McCarthy (R; California), who is the favorite to become Speaker of the House, has discussed that the focus will be on less fiscal spending, an examination on ongoing funding to Ukraine, border security, and investigations into the Biden administration.

What about the debt ceiling?

While the exact date is unclear, Congress will need to raise the roughly $31.4 trillion debt limit sometime by the Summer or Fall of 2023.

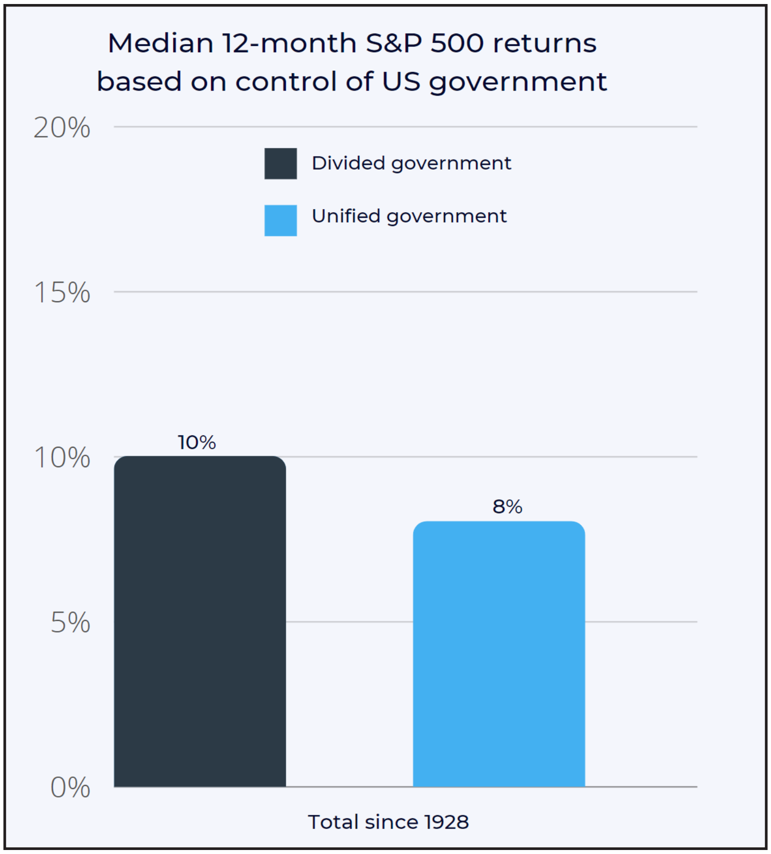
The most well-known debt ceiling battle occurred in 2011 under a Republican House and Democratic Senate. At that time, Standard & Poor's (S&P) downgraded the United States debt rating from AAA (outstanding) to AA+ (excellent). According to the Government Accountability Office, the downgrade increased the Treasury's borrowing costs by about $1.3 billion in that fiscal year.

Current House Speaker Nancy Pelosi recently stated that Democrats will attempt to raise the debt ceiling during the lame-duck session of Congress. If Democrats are not able to pass the legislation quickly then there will need to be a bipartisan agreement under the new Congress. Key House Republicans have signaled that they will seek spending cuts when they negotiate. Unfortunately, markets may have to deal with another debt ceiling fiasco.

Please see our previous Client Questions on The Debt Ceiling and The Federal Debt.

S&P 500 Performance under Divided Government

Since 1928, the S&P 500 has returned about 10% under a divided government versus about 8% under unified government. Markets do not like uncertainty. The difference in performance is likely due to a more predictable environment under divided government as typically no major tax or spending legislation gets passed.



Source: Goldman Sachs Global Investment Research

In 2023, a divided government is overall a market positive as it decreases the odds that any major spending, tax cut, or tax hike packages get passed. The market's top concern is still inflation so any fiscal stimulus through either government spending or tax cuts would likely be negative. Additionally, tax hikes that decrease corporate earnings or consumer spending would also likely not be received well. For the time being, gridlock is good.

Our portfolio positioning and outlook is based on four pillars: Monetary Policy, Economic Growth, Corporate Earnings, and Valuation. While the makeup of government will impact the four pillars, it is only one of many factors. Therefore, we would not make adjustments based solely on the makeup of Congress.

Please see our most recent commentaries to view our latest market outlook.

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