Global economy

ElectionWatch 2018: The "blue shift"

In line with a historically average midterm election result, Democrats picked up around 36 House seats, securing a modest majority in the House of Representatives. But Congress will be divided, with Republicans adding a handful of seats to their Senate majority.

With little bipartisan agreement on targets for spending cuts, deficits are likely to remain elevated, which should put upward pressure on bond yields and downward pressure on the US dollar.

Overall, the election outcome is neutral for risk assets. Within US equity sectors, we see limited impact, due largely to the limits on passing legislation in a divided government. But there are two “swing sectors” — financials and industrials — where potential tail risks may arise from congressional politics.

For investors feeling disappointed or frustrated by the election results, we recommend against translating those political concerns into economic or market pessimism.

Additional reading

For more information on policy and market impact, visit ubs.com/electionwatch.

Please also read this Special Washington Update, from our UBS US Office of Public Policy, for additional insights into the election’s political ramifications.

Historical norm

- Gridlock develops, requiring compromise to pass most major legislation. Democrats launch myriad investigations against the Trump administration.
- President Trump continues to use executive actions to loosen regulations, and to use tariffs to pressure trading partners.

Investment implications
- Neutral for risk assets (Base case)

Gridlock, with pockets of compromise –
- Without common ground on areas to cut spending, the budget deficit remains higher than usual, putting upward pressure on long-term government bond yields.

Infrastructure is one area where President Trump and Democrats may find common ground, but they tend to disagree on size, substance, and funding. This would be a modest positive for risk assets (especially a basket of infrastructure-related companies), but add to pressure on bond yields and the US dollar if the package is largely deficit-financed.

Government shutdowns are likely in this scenario, but markets have historically shown very little reaction to these episodes.

Drug price controls are a possible area of compromise, and would weigh on global pharmaceuticals.

Policy possibilities
- Likely
  - Gridlock
  - Government shutdown
  - Regulatory relief continues

- Possible
  - Infrastructure
  - Drug price controls
  - Supreme Court freeze
  - Impeachment (but removal unlikely)

- Unlikely
  - Debt ceiling showdown
  - Obamacare repeal
  - Entitlement reform
  - Tax reform 2.0
  - Border wall
  - Congress constrains trade authority

Source: UBS

This report has been prepared by UBS Financial Services Inc. (UBS FS). Please see important disclaimers and disclosures at the end of the document.
Politics and Policy

With a divided government, we expect to see a pick-up in gridlock with pockets of compromise to push through must-pass legislation. With Congress relying on “midnight deals” and ultimatums to gain bargaining leverage, government shutdowns are a risk. Although we would expect government shutdowns to be short-lived and have little lasting impact, markets may worry over the potential threat that a “no deal” outcome could trigger the return of deep “sequestration” spending cuts.

Although we don’t expect much substantive legislation to become law over the next two years, both parties will push legislation to begin building the planks of their party platform for the 2020 election.

In the House, congressional investigators will make full use of their subpoena power to open oversight investigations into myriad facets of the Trump administration’s officials and policies. Impeachment proceedings are possible in the House, but they are a political risk. Instead, we expect to see congressional hearings first, with a vote becoming more likely if there is substantive evidence of specific impeachable offenses. As we’ve noted before, there will be a high hurdle of evidence to secure any Republican votes; without an avalanche of Republican support in the Senate, President Trump will not be convicted and removed from office.

In the absence of bipartisan congressional opposition, the Trump administration will continue to exert control over many major policy areas, such as regulation, trade, and immigration.

Markets

In our view, the legacy of this election is far more likely to be seen in politics than in policy.

On trade – probably the most important market-impactful policy issue today – we’ve seen very little sign that the election will have an impact. Republican voters largely support President Trump’s trade negotiations at the moment, and we would need to see a change of heart among the electorate before there is any bipartisan push to curtail the executive branch’s authority regarding tariffs. Trade was also not a major rallying cry for Democrats during the campaign, suggesting that there is little appetite for a fight.

That being said, there are areas of potential compromise. Both President Trump and congressional Democrats have expressed support for more infrastructure investment and limitations on drug prices. Identifying a source of funding for the former initiative will pose a challenge, and opposition in the US Senate may reduce the risk of a more extreme (and market-impactful) solution.

In addition, some parts of the US equity market could begin to face headwinds over concerns about a change in tone about issues like regulation. Let’s look at the two “swing sectors” that we highlighted in our Sector Impact report:

Financials

Representative Maxine Waters looks poised to chair the House Financial Services committee. She has long opposed deregulation efforts for financials. In our view, there is a very low chance of increased regulation under this Congress, but markets will begin to fret about “what dreams may come” if Democrats win a follow-up victory in 2020.

After losing their House majority, Republicans will likely need to abandon the hope of a legislative solution to amending the Dodd-Frank Act for now. This will be on their “wish list” for legislation after a potential 2020 election victory, but in the meantime, we expect the Trump administration to continue chipping away at regulations without the need for legislative changes. With key regulatory heads already in place, deregulatory initiatives should continue at their present tempo.
Despite potential perceived headwinds from House committee hearings, there are bigger factors at play, and political considerations are unlikely to override the fundamentals, and we continue to recommend an overweight to financials.

**Industrials**

On the margin, the sector faces increased tail risk under the divided Congress. In particular, gridlock can be particularly painful for industrials given the fact that any failure to pass a defense budget and other stop-gap spending measures would trigger so-called “sequestration cuts” that could have a significant impact on defense spending. With current defense spending running well above the caps defined by the Budget Control Act, failing to reach a budget agreement could result in an up to 13% cut in defense spending in a worst-case scenario.

However, we see the odds of this result as very low, as growth in defense spending has received bipartisan support in the past. Both parties would prefer to avoid disruptions to this vital sector of the economy. Most likely, the overall growth in defense spending could be on the chopping block – even if that means only that the spending increase will be less than expected – if the Democrats want to free up room in the budget for their own initiatives. With discretionary non-defense spending already cut to the bone under the current budget (making up only 16% of federal spending), defense spending would be a key target in any bipartisan budget deal.

The aforementioned budget concerns are more of a risk case than a likely outcome. But while politics is not a main driver for the sector, geopolitics is having a more meaningful influence on fundamentals. We recommend a moderate underweight to industrials, in part due to concerns about trade risks that haven’t yet abated. Though we see a high probability of an “upside risk” amicable end to trade tensions, our base case sees trade tensions continuing to escalate before a resolution.

**Conclusion**

We believe a divided Congress will result in partisan gridlock on most policy issues as both parties pivot their attention on the next presidential election. Congress is expected to cede authority to the president in the areas of international trade, immigration enforcement, and agency deregulation. These three policy areas have already become the province of the executive branch, so substantive shifts in policy are unlikely.

As we recently noted, markets will likely rally in the days ahead, but US politics have little to do with market returns. For most investors, this election won’t be a meaningful variable when making investment decisions. If uncertainty over the election outcome was a reason that you were hesitating to put excess cash to work, this may be an opportunity to do so.

Data shows that political outcomes can skew economic confidence, and studies tell us that there can be a heavy toll when investors allow their political fears to overshadow their investment decisions. So for investors feeling disappointed or frustrated by the election results, we recommend against translating those political concerns into economic or market pessimism. As the saying goes, perhaps “the best revenge is a life well lived.”

We reiterate our existing House View that the odds of an economic recession remain low, and that’s largely unchanged by US political considerations. Against a backdrop of robust corporate earnings growth, attractive valuations, and a solid economy with little risk of overheating, we recommend an overweight to global stocks versus government bonds. Within US large-cap stocks, we favor value over growth.
Appendix

Research publications from Chief Investment Office Global Wealth Management, formerly known as CIO Americas, Wealth Management, are published by UBS Global Wealth Management, a Business Division of UBS AG or an affiliate thereof (collectively, UBS). In certain countries UBS AG is referred to as UBS SA. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. We recommend that you obtain financial and/or tax advice as to the implications (including tax) of investing in the manner described or in any of the products mentioned herein. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS). All information and opinions as well as any prices indicated are current only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time, investment decisions (including whether to buy, sell or hold securities) made by UBS and its employees may differ from or be contrary to the opinions expressed in UBS research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. This report is for distribution only under such circumstances as may be permitted by applicable law.

Distributed to US persons by UBS Financial Services Inc. or UBS Securities LLC, subsidiaries of UBS AG. UBS Switzerland AG, UBS Deutschland AG, UBS Bank, S.A., UBS Brasil Administradora de Valores Mobiliarios Ltda, UBS Asesores Mexico, S.A. de C.V., UBS Securities Japan Co., Ltd, UBS Wealth Management Israel Ltd and UBS Menkul Degerler AS are affiliates of UBS AG. UBS Financial Services Incorporated of Puerto Rico is a subsidiary of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. UBS Financial Services Inc. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the “Municipal Advisor Rule”) and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule.

UBS specifically prohibits the redistribution or reproduction of this material in whole or in part without the prior written permission of UBS. UBS accepts no liability whatsoever for any redistribution of this document or its contents by third parties.

Version as per April 2018.

© UBS 2018. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.