

Special Coverage: US Midterm elections: implications of the blue sweep

Key takeaways

- News channels including CNN project a blue sweep following the midterm elections. Markets had been increasingly expecting this scenario, which may limit the impact, especially as the outcome itself it does not alter the growth or inflation outlook.
- President Trump's conciliatory tone also reduces the impact. Potential limits on AI, more regulation and difficult budget negotiations are concerns for markets, while some hopes of measures to address the cost of living and green initiatives could drive pockets of optimism. The Democratic sweep will constrain the president's legislative and fiscal agenda, increase reliance on executive actions and raise the risk of a budget gridlock, while leaving substantial authority over trade and foreign policy with the White House.
- Investors will be reminded of historical market patterns, which show that US equity markets were consistently up in the 6 and 12 months following the midterm elections, with 1930 and 1938 being the most recent exceptions. This is usually explained by the increased clarity following the results (as well as the dip we often see ahead of the elections). Investors are best served by setting their strategy with an eye on structural trends, while focusing on quality, differentiation and diversification.



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What happened and the investment implications

- According to CNN and other news channels, Democratics are projected to win control of both the House and the Senate, with the surprise being the size of their majority. The Democratic sweep will constrain the president's legislative and fiscal agenda, increase reliance on executive orders and raise the risk of a budget gridlock, while leaving substantial authority over trade and foreign policy with the White House.
- For risk assets, two topics will matter. Firstly, the reaction function of the US administration and any measures it wants to push through before 3 January, as the new Congress is not seated and Republicans are still in control. How the Middle East crisis evolves will also be key, but it is not clear that this is influenced by the election outcome, and markets have been more hopeful recently, with oil prices falling.
- Secondly, AI regulations will be a key concern, especially as AI determines so much of US economic and EPS growth. Overnight, we saw mild weakness in Asian markets and a small dip in the Nasdaq futures. That said, there is some tentative buying in South Korea – a very volatile market – where investors may be seeing value emerging. We also note that in the US, tech is now trading at valuations close to a 5-year low and is slightly cheaper than other sectors. Easing the concern is that regulation at the national level could be blocked by the President's veto, but local opposition (Not In My Back Yard - NIMBY), electricity costs and connectivity issues have already accelerated more local regulations.

- Financial regulation could be a negative for that sector, but it has already been underperforming in recent months. On the other hand, the energy transition could see more support from Democrats – either at the national level, if they can get past any vetoes, or at the local and state levels. We see renewable energy as essential to achieving the energy independence objective.
- Any weakness in risk assets could provide support for US Treasuries and other safe-haven bonds, but the impact could start to fade. Difficult budget negotiations are a concern but may also limit the ability of either party to spend on military action (Republicans) or consumer support (Democrats). As such, we think real yields will remain elevated, limiting the potential for any bond rally, but generating attractive income. We continue to focus on clipping coupons from quality bonds with medium maturities to generate income in portfolios. We also like the fact that equity/bond correlations have been coming down, improving bonds' diversification characteristics.
- Overnight, the USD has been on the backfoot as blue-sweep expectations intensified. Limits on the administration's legislative agenda, and limits on AI could reduce people's perception of 'US exceptionalism', weighing on the USD. To the extent that this continues to drive US yields down, it could also weigh on the USD in the short term. That said, we think quality USD bond yields remain attractive, and USD should find support from that, as well as the many opportunities in USD public and private markets.

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