ADDENDA
CAPITAL

Author: **Richard Beaulieu, CFA,** *Vice-President and Senior Economist*
In collaboration with: **Bill Onslow, CFA,** *Vice-President, US Equities*

The People Have Spoken Again... and a Majority Voted for Gridlock

In an election seen by many as a referendum on Donald Trump's presidency and agenda, the American electorate chose to put a damper on the legislative power of the President and the Republican Party. Since the presidential election in November 2016, the Republicans have had full control of the legislative levers of the Federal Government. They held a majority of 235 of the 435 seats in the House of Representatives, 51 of the 100 seats in the Senate, and the executive powers of the Presidency. Following Tuesday's mid-term election, the Democrats have regained control of the House of Representatives, with at least 224 seats confirmed, while the Republicans slightly increased their majority in the Senate, with a net gain of two seats among the 35 up for re-election.

For those focusing on the political significance of this election, the record turnout for a mid-term election of 113 million voters must carry some weight. From here on, the President will have to deal with a re-energized Democratic House hostile to many Republican priorities. We should not be surprised if the President uses executive orders as a preferred means to further his agenda, attempting to reach way beyond their normal purview. This could turn out into an entertaining reality show as Donald Trump attempts "the Art of the Deal" on Nancy Pelosi, likely the new Democrat Speaker of the House.

Economic Impacts and Market Implications

Financial markets let out a sigh of relief when the results of these mid-terms turned out broadly as predicted. The next day, equity markets rallied and bond prices held firm or increased slightly globally. Pollsters and pundits were also relieved to regain some of their lost credibility after the fiasco of their predictions in the last presidential election.

Markets typically react violently to negative surprises and fortunately this election did not have any. Moreover, investors understand that in the United States, by design of the Founding Fathers, the political structure favours the possibility of a divided power base. A divided outcome following a mid-term election should be viewed as a frequent occurrence rather than an exception in the second half of an initial Presidential term. It also preserves the current policy *status quo*. Investors are confident that the positive economic impact of U.S. corporate tax reform and deregulation will not be undone. However, this shift in political power means that, looking forward, hopes of additional fiscal stimulus from further tax reduction and additional defense and infrastructure spending, beyond what has already been appropriated, have been dashed. This might even be viewed as a desirable shift in fiscal priorities given the potential inflationary impact of still additional stimulus at this late stage of the economic cycle.

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The shift in political power might also bring the spotlight back on the ongoing large fiscal deficit and growing public debt. The Democrats will surely attempt to apply maximum political pressure when the new Congress debates increasing the debt ceiling (in March) or authorizing the appropriation of additional funds to lift some tough budget caps on defense and other domestic spending (in October). In addition to the ongoing upward trend in the monetary policy rate, this renewed focus on the deficit and rising interest costs is likely to add fuel to bond yield variability.

Another impact from this political power shift might be on trade policy, an area of particular interest to financial markets. Of more immediate significance to Canada's economic prospects is the adoption by the House of the new USMCA trade deal replacing NAFTA. Typically, the Democrats have not been the staunchest free-traders and are not likely to concede an easy victory to President Trump by rubberstamping the deal. This could lead to some attempts to modify certain elements and delay implementation. This could bring back some uncertainty to international trade prospects and trigger some market volatility, notably in exchange rates on the Canadian dollar and the Mexican peso.

Finally, this mid-term election is likely to prove at most a marginal influence on the durability of the current economic cycle. Recessions typically happen in response to strongly restrictive monetary policy when inflation becomes a serious threat or when financial excesses unravel in a liquidity crisis. So far in the current cycle, the forces of inflation remain contained and no financial excesses are deemed to have reached dangerous proportions. This is not to say that the current upward path of growth cannot experience some bumps as the expansion carries on. It can, but we assess the probability of an imminent recession as still low.

info@addendacapital.com

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