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Amundi
ASSET MANAGEMENT

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INVESTMENT TALKS

US Midterm election: A divided Congress opens two possible scenarios

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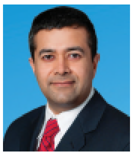

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- ***Key takeaway:*** *In the midterm election Democrats win the House and the GOP (Grand Old Party) strengthens its position in the Senate.*
- ***Possible scenarios ahead:*** *We believe there are two paths that could emerge between the Democratic leadership in the House and Trump. The first path is the emergence of divided government, leading to* ***very little meaningful legislation*** *enacted. The second path is a constructive one where there are* ***areas of commonality*** *between Trump and the Democratic leadership in the House (infrastructure spending). The biggest downside risk to financial markets from the midterm elections - a* ***repeal*** *of President Trump's fiscal tax plan – is extremely unlikely, as the Democrats do not have a veto proof majority in the House or in the Senate. However going forward, Trump will need to work with a Democratic House on the budgetary side and will no longer be able to drive fiscal policy, as it remains the purview of the House. Trump will maintain the unfettered ability to impose tariffs, so there continues to be high probability of a further escalation in trade tensions between US and China with the imposition of tariffs on the final $267bn in Chinese exports to the US.*
- ***Market reaction and investment implications:*** *We do not expect any significant immediate market reaction, however the prospect of key legislation will determine future market evolution.* ***Fixed income*** *markets could come under some pressure if the President and Congress approve a new stimulative fiscal program however we expect 10 year yields to remain around the current levels in the coming months. For* ***equities****, the historical precedent has been for markets to underperform ahead of the midterm elections and then rally until year-end. We expect this trend to be confirmed. After the midterm election, moving towards 2019, equity markets will shift their focus more to fundamentals such as earnings sustainability. The outlook is still positive for US equity in 2019, but with a strong focus on selection as the economic and financial cycle mature.*

What are the main implications of midterm election results? Do you see the crucial policies of Trump's agenda (fiscal policy, immigration) to be affected by the new Congress?

Electoral results broadly confirmed our central scenario of a divided Congress, with Democrats winning the House and the GOP reaffirming its control in the Senate. We believe there are two paths that could emerge between the Democratic leadership in the House and Trump. The first path is the emergence of divided government where the real prospect of gridlock has risen, leading to very little meaningful legislation enacted. The second path is a constructive one where there are areas of commonality between Trump and the Democratic leadership in the House. There are prospects of a modest infrastructure spending program between $100 and $300bn. There could also be renewed momentum to modify ACA[1] by strengthening the language over preexisting health care. Polls indicate health care was the decisive factor that tilted the election in favor of the Democrats. There could be a renewed effort at immigration reform. We could see a final solution on DACA[2] (The Dreamers) with a potential compromise that might lead to an increase in homeland security spending. The biggest downside risk to financial markets from the midterm elections is a repeal of Trump's hallmark legislative accomplishment - the fiscal tax plan (Tax Cuts and Jobs Act of 2017). The Democrats do not have a veto proof majority in the House or the Senate so it will be nearly impossible to attain the 2/3rd needed to repeal it. This eliminates the most significant downside political risk to financial markets. However going forward, Trump will need to work with a Democratic House on the budgetary side and will no longer be able to drive fiscal policy, as it remains the purview of the House. The re-emergence of divided government will not hinder Trump's ability to

"Trump will need to work with a Democratic House on fiscal policy but its ability to impose tariffs will remain unfettered".

[1] ACA. Affordable Care Act.
[2] DACA: Deferred Action for Childhood Arrivals

implement executive orders. Trump will continue to rely on this as a way to circumvent Congress, especially in non-budget related areas, whenever possible. Trump also has the unfettered ability to impose tariffs. There continues to be high probability of a further escalation in trade tensions, with the imposition of tariffs on the final $267bn in Chinese exports to the US.

"The prospects of a major change in the Federal Reserve mandate has been reduced dramatically with the Democrats controlling the House".

Do you expect the new Congress could impact in anyway the stance of the Trump's administration on monetary policy and on the Federal Reserve?

The prospects of a major change in the Federal Reserve mandate has been reduced dramatically with the Democratic control of the House. Previously, a vocal minority within the Republican Party had advocated removing the full employment part of the Fed's dual mandate (maximum employment and price stability). Otherwise, we expect no change in the Federal Reserve mandate. On the margin, the relationship between Chair Powell and Congress may be a bit warmer since Democrats have been less critical of the dual mandate and the internal operations of the Fed. Should Congress pass another stimulative fiscal program, more likely in the form of higher infrastructure spending, the Fed is likely to respond with tighter policy than expected by the markets. If there is likely to be any change, it will come from the President and not the Congress. President Trump has been somewhat critical of the Fed's tighter policy. While highly unlikely, under the Banking Act of 1935, the President can terminate the Fed chairs term on "cause". That is a low hurdle to potentially remove a Fed Chairman.

"A stimulative fiscal program could generate pressure on the front end of the curve and would be positive for equities".

What could be the implications of the election results on fixed income and FX?

We do not expect any significant immediate market reaction, however the prospect of key legislation will determine future market evolution. Fixed income markets could come under some pressure if the President and Congress approve a new stimulative fiscal program. The increase in infrastructure spending will stimulate growth allowing the US economy to maintain an above trend growth rate. This could prompt the Fed to tighten policy beyond neutral[3] and push up Treasury yields, perhaps leading to an inverted yield curve. Expectations of a Fed tightening beyond neutral will raise jitters on recession concerns moving forward and put pressure on investment grade and high yield markets. Overall, we expect 10 year yields to remain around the current levels in the coming months. At the same time, as profit growth slows and the Fed tightens, credit will also begin to experience some pressure. Therefore, in our view, the best choice for investors is to limit exposure to credit, diversify the portfolio smartly and to take a flexible duration management (close to neutrality at this stage). We like some segments of the fixed income market in particular securitized assets, including MBS. With the Fed tightening cycle coming to an end, we would expect an attractive entry point into US bonds, and potentially credit as well. The USD is likely to remain broadly unchanged in a divided government, however the USD could appreciate if we see tighter monetary policy in response to a further easing in fiscal policy.

"After the midterm elections, the markets will shift their focus more to fundamentals such as earnings sustainability".

And on the equity market?

For **equities**, the historical precedent has been for markets to underperform ahead of the midterm elections and then rally until year-end. We expect this trend to be confirmed. With a divided government, we expect higher infrastructure spending will be taken as a positive sign for equities. After the midterm elections, the markets will shift their focus more to fundamentals such as earnings. A further escalation in trade is something to look carefully, as it poses downside risk to earnings. Overall, we expect equity markets to trend higher next year, in line with earnings growth, but at a more moderate pace supported by the positive economic backdrop, with an additional lift potentially coming from the investment side. Selection of themes, sectors and single names will be increasingly relevant, as the maturity of the cycle could eventually become a headwind, should the Fed move too much above the neutral rate, which is always difficult to time. At this stage, the outperformance of growth stocks looks extreme and focusing on valuations makes increasing sense; combining quality and value could be a winning formula going forward to invest in US equities.

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3 So-called "neutral" monetary policy, also called the "natural" or "equilibrium" rate, is the federal funds rate rate that neither stimulates nor restrains economic growth.

Important Information

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

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