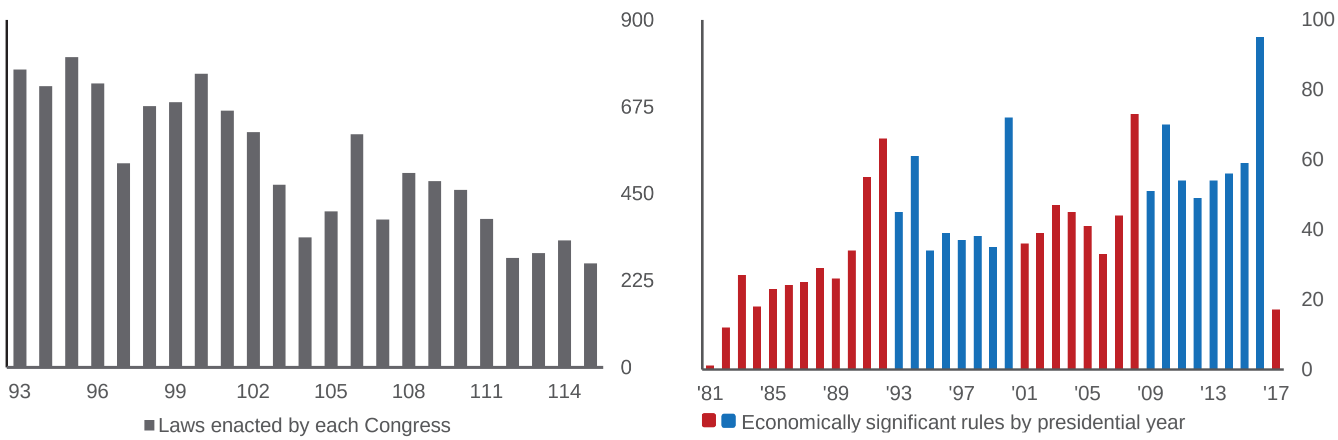
MIDTERM EXAM

We think the U.S. midterm elections on November 6 will likely be a bigger media event than a market event. Current polls indicate the Democrats may take control of the House of Representatives, but the Republicans will hold control of the Senate. So a divided Congress will be in no better position to pass legislation than they are today — but the market hasn't been expecting any major legislation to be forthcoming. Under a Republican Senate/ Democratic House scenario, we envision a modestly positive impact on healthcare stocks and a modestly negative outcome for the consumer sector.

While polling data and history point to the likelihood of the Democrats taking control of the House, the recent poor predictive record of polls keeps us from being too confident in that outcome. The good news is that we don't think the economic or investing outlook will be much different in that scenario. The markets aren't counting on meaningful legislation being passed, and the tax cuts and deregulatory efforts of President Donald Trump's administration will remain in place. Neither party is in a position to surpass the 60 votes required in the Senate to clear the filibuster, limiting the legislation that can be passed. In addition, neither party will be able to clear the higher hurdle of a two-thirds majority to override a presidential veto. As Exhibit 1 shows, there has been a slowdown in new legislation passed over the last year, but the real story is on the regulation front. The issuance of economically significant rules plummeted in the first year of the administration, which has boosted business confidence — and this won't be upended by a change in Congress during the midterms.

EXHIBIT 1: LEGISLATION FALLING, ALONG WITH NEW REGULATIONS

The biggest change has been a significant fall-off in new regulations issued by government.



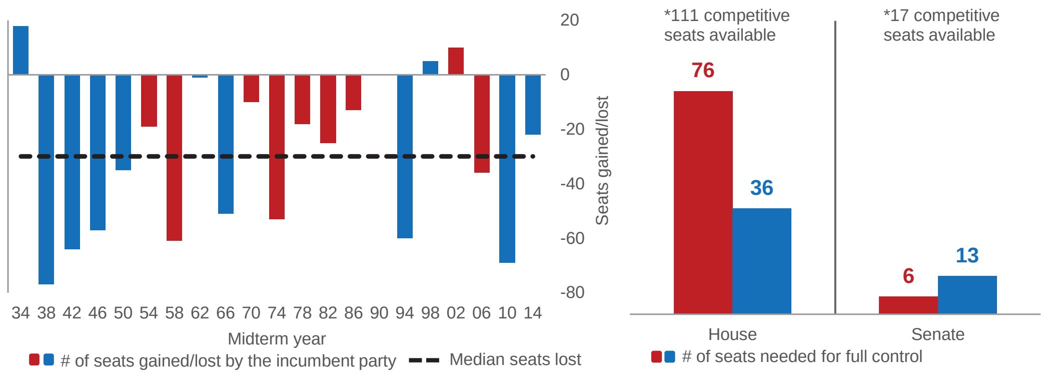
Source: Northern Trust Investment Strategy, Govtrack.us.*Note: 115th Congress is still in session. Red bars represent Republican president and blue represent Democrat.

OUTLOOK FOR THE HOUSE: DEMOCRATS FAVORED TO TAKE CONTROL

The House currently consists of 235 Republicans, 193 Democrats and seven vacancies. A party needs 218 for a majority and all 435 seats are up for election. Forecaster FiveThirtyEight estimates an 83% chance that the Democrats will take control of the House, up from a 71% chance in August. The Cook Political Report, based on race by race analysis, predicts the Democrats will pick up between 25 and 35 seats — with 25 seats just reaching the 218 majority figure. As shown in Exhibit 2, Republicans will need to win 76 seats that are currently considered competitive, while the Democrats will only need to win 36 of those seats. Looking at national polling data, Democrats currently hold a 7.7% advantage over Republicans in the generic ballot, a poll that has predicted the House popular vote correctly the past four midterm elections. We do note, however, that individual race polling appears closer than the national numbers, so the election could be closer than the national polls indicate. Historically, when the president's approval rating has been under 50%, his party has lost an average of 40 seats in the House. The current Real Clear Politics average approval rating sits at 44%.

EXHIBIT 2: INCUMBENTS TEND TO LOSE SEATS DURING MIDTERMS

Republicans (red) have a headwind versus Democrats (blue) in the House, but a tailwind in the Senate.



Source: Northern Trust Investment Strategy, American Presidency Project, Cook Political Report.
*Competitive seats are those that are not considered "solid" or in the case of Senate "not up for vote."
House forecast as of 10/23/2018. Senate forecast as of 10/19/2018.

OUTLOOK FOR THE SENATE: REPUBLICANS FAVORED TO RETAIN CONTROL

The Senate currently consists of 51 Republicans and 49 Democrats. A majority requires 51 seats; however Republicans more or less only need 50 seats as the vice president has the tie-breaking vote in the case of a 50-50 split. There are 35 seats up for election, 26 and nine of which are currently held by Democrats and Republicans, respectively. The Democrats will need to win 28 of the 35 seats in order to gain control, reflecting a gain of two seats. FiveThirtyEight's model forecasts a 21% chance that this occurs, down from a 28% chance in August. Of the 35 seats up for election, 26 are considered likely Democrats ("likely Dem" or "leaning Dem"), eight are considered Republican ("likely GOP" or "leaning GOP") and one is a toss-up. Over the past 21 midterm elections, the president's party has lost an average of four seats in the Senate. This year's election is not expected to follow that trend as Republicans are expected to hold their current number of seats.

The degree of ease in which Congress can pass legislation is, of course, of interest to the financial markets. In order for a bill to be enacted into law it needs both majority approval from the House and effective 60% approval from the Senate in cases where filibuster rules still apply. In every instance since 1946, the S&P 500 Index has been higher one year after midterm elections than it was the day of the elections. However, the past is not always an indicator of the future and the implications of the midterm elections extend beyond a one-year horizon. Possible election outcomes and their far-reaching likely impacts are outlined below:

Scenario 1: Democrats Take Control of the House and Republicans hold the Senate. This is the consensus expectation, and FiveThirtyEight pegs this as a 66% probability. Historically, the average U.S. equity return under a Republican president and split Congress is 7.7%, the lowest out of possible administration compositions (based on market returns from 1953-2017). While a split Congress makes it very difficult to pass major legislation, this does not mean there won't be any fireworks. With control of the House, the Democrats will have subpoena power, leading to more investigations. Furthermore, it is likely that trade war activity with China will pick up after the elections. Trump has been careful to not raise tariffs too much ahead of the elections amid concerns from voters. However, it is important to note that many policy changes made during Trump's tenure, including those related to trade, have been made through executive order.

Scenario 2: Democrats Take Control of Both the House and the Senate. This is viewed as an unlikely outcome, mostly due to the outlook for the Senate. FiveThirtyEight puts this scenario at a 17% probability, and PredictWise puts the odds of a Democratic Senate at just 13%. The average U.S. equity return under a Republican president and Democratic Congress has been 8.6%, the second lowest out of possible administration compositions. This outcome may lead investors to perceive a greater chance of an administration change in the 2020 elections, with a resulting change in legislation and executive actions. Legislation will still be difficult to pass, but the reconciliation process may allow for targeted progress. There would be increased rhetoric targeting drug companies and financial firms, while there is a chance that infrastructure bills would gain more traction. The president would continue to use his executive power to push ahead in the trade war, while Congress will have to approve new deals such as the new U.S.-Mexico-Canada Agreement (USMCA), the potential successor to NAFTA.

Scenario 3: Republicans Hold Both the House and the Senate. This is viewed as an unlikely scenario based on the uphill battle in the House. FiveThirtyEight puts this scenario at just a 13% probability, with PredictWise assigning a 34% probability of a Republican House. The average U.S. equity return under a united Republican president and Congress is 19.1%, the highest out of possible administration compositions. Under this outcome, Tax Reform 2.0 has the greatest chance of being approved. However, the bill would still need approval from 60 senators. This seems unlikely — it would require votes from a handful of Democrats, all of which opposed last year's tax bill. The centerpiece of this bill is to make many of the changes from last year's bill permanent. Reconciliation, the process through which last year's tax bill was approved (requiring only 50 votes in the Senate), may not be an option as it is for bills that do not extend outside of a 10-year budget window.

These three scenarios only add to 97%, as they assign a 3% probability to a fourth scenario: the Republicans keeping the House but losing the Senate.

Our equity research team has analyzed the possible election scenarios, and we include their conclusions in Exhibit 3. The following are the potential impacts on the most affected sectors:

Healthcare: A split Congress is likely to be considered the best-case scenario for healthcare. While there is some bipartisan agreement on drug price controls, a split Congress preserves the status quo to the largest extent. A Democratic sweep would significantly increase the rhetoric toward single-payer. While nearly impossible to achieve politically, it would increase headline risk — likely all the way through the 2020 election. Full Republican control could serve as validation that Republicans should take another run at the Affordable Care Act, increasing uncertainty regarding coverage and enrollment.

Technology: The biggest political issues facing tech are the trade war with China and the potential for new regulation of the internet and digital media. Both issues appear to have bipartisan support, so we do not expect that a potential change in control in Congress will change the likely outcomes. There has also been more discussion of antitrust investigations into the large internet platforms, which might fade if the Democrats win control of Congress. Immigration is another issue affecting technology, given the high usage of H1-B visas. This has been on the back burner of late, but the sector could benefit if the Democrats gain seats and the timing of reform is pushed out.

EXHIBIT 3: SECTOR-LEVEL IMPACT OF MIDTERM ELECTIONS

	Rep Senate / Dem House	Dem Sweep Both	Rep Keep Both
Healthcare	MODEST POSITIVE Best case outcome for healthcare. Drug price controls possible, but largely preserves the status quo, avoids more draconian changes.	NEGATIVE Rhetoric will increase on single-payer, which would likely continue into the 2020 elections, leaving significant uncertainty for the sector.	NEGATIVE Republicans will likely feel emboldened to again go after the ACA, increasing uncertainty regarding coverage and enrollment.
Technology	NEUTRAL Bipartisan support for regulation of internet and digital media firms. We expect something similar to GDPR in the EU, which should be manageable.	MODEST POSITIVE Less potential disruption from immigration/H1-B visa reforms.	NEUTRAL Discussion of possible antitrust investigations into the large internet platforms under full Republican control.
Industrials	NET NEUTRAL Perceived small net negative for defense spending. Better odds of a small infrastructure package, providing a modest boost to industrials.	NEG DEFENSE / POS INDUSTRIAL Perceived larger net negative for defense (do not see much change in spending however). Odds of a much larger infrastructure deal improves.	POSITIVE DEFENSE Perceived positive for defense. May lead to more prolonged antagonism with China, hurting general industrial activity.
Financials	NEUTRAL Existing regulatory environment will continue on track, as most regulatory positions have been filled. Some headline risk, but manageable.	NEGATIVE A negative for financials. New regulatory bills very difficult to pass, but plenty of noise, and fears of what could come in 2020.	POSITIVE A net positive for financials, but likely doesn't materially change the trajectory of deregulation.
Consumer	MODEST NEGATIVE Some risk of increased uncertainty about the permanency of tax cuts as well as headline rhetoric and/or pressure to raise minimum wages.	NEGATIVE Higher minimum wages and less permanency in the tax cuts would be negatives for the retailers/restaurants.	POSITIVE Potential to make cuts permanent would help consumer, along with less risk of minimum wage hikes and healthcare coverage.

Source: Northern Trust Investment Strategy, Northern Trust Equity Research.

Industrials: The two areas that are most often highlighted are defense and infrastructure spending. A Democratic win of the House and/or Senate is commonly viewed as a net negative for defense spending as it is assumed that they would prefer to redirect defense funds towards other priorities. We see the current defense spending as driven by the need to replenish the military, where readiness and capability have been reduced due to the sequester. Additionally, the re-emergence of threats from Russia and the continued growth of defense spending in China should drive continued funding needs. Increased infrastructure spending is often viewed as more likely under a split Congress or under Democratic control. We would expect to see engineering and construction companies perform well if Democrats win the House and/or Senate.

Financials: We expect the regulatory environment for financials to remain steady/on track if Republicans can hold the Senate as expected. The majority of financial regulatory positions have already been filled. There will likely be increased headline risk for financials if Democrats win the House or the Senate. That being said, Democratic regulatory bills are unlikely to pass. Regulatory items such as mortgage finance reform will be even harder to pass under a divided Congress.

Consumer: A split Congress may increase uncertainty about the permanency of tax cuts as well as headline rhetoric and/or pressure to raise minimum wages, acting as a modest overhang for consumer names like retail and restaurants. Under a Democrat-controlled Congress scenario, the risks of higher minimum wages and less permanency in the tax cuts would be negatives for retailers and restaurants. If the Republicans maintain their advantages in both the House and Senate, we'd expect to see a push in making the tax cuts permanent, which would be constructive for consumer-sentiment and thus favorable for retailers and restaurants. It may also lead to another look at reforming entitlement programs — any further cuts to SNAP food assistance benefits, unemployment assistance or healthcare coverage would be a potential modest offsetting headwind for the supermarkets/discounters, dollar stores, and drugstores.

CONCLUSION

The unreliability of polling data should cause anyone to be hesitant in confidently predicting election outcomes, and we have little doubt that surprises will emerge from this election.

In addition to the national races, there are important state battles for governor and legislative control. Republicans have gained meaningful control at the state level in recent elections, and the polls are currently forecasting some loss of that control.

A split Congress will not meaningfully affect the legislative outlook, but it could make day-to-day governing more challenging. Passage of the USMCA trade agreement will likely be easier under a Republican controlled Congress, but Democrats may not prove to be a substantial roadblock to passage. There doesn't appear to be coordinated opposition within Congress to the administration's trade actions so far, so the Democrats may not prove to be an organized opponent in this regard.

Finally, a divided Congress may present greater uncertainty around fiscal deadlines and the necessity of passing funding or debt-ceiling legislation. All in all, we don't expect the outcome of the midterms to materially affect the economic or financial market outlook over the next year. We are — and investors will likely be — more focused on the outlook for growth and monetary policy. We've been expecting growth to moderate into 2019, leading the Federal Reserve to back off plans for steady rate increases over the next year. If we are wrong, it will be because either growth is better than we expect (a good scenario) or the Fed doesn't back off (the bad scenario). We expect to have better visibility on this issue after the December Fed meeting, where they have a chance to update investors on the key issues they will be assessing as we enter 2019.

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