Midterm redux: Partial 'Goldilocks' outcome, though Fed and China still loom

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Our view of the historical midterm elections (the largest midterm voter turnout in the history of the country)? It was probably as close as investors could have gotten to threading the needle toward a positive outcome. With the Republicans' Senate majority strengthened and the Democrats' House majority narrow enough that an overly radical agenda from that chamber is ruled out, investors can now cheer:

- **Two key pillars of Trump's pro-growth agenda remain solidly in place for two more years … and likely six.** With a divided House, policy gridlock in Washington is back; we expect very little in the way of legislative cooperation between the embittered parties now opposing each other in Congress as well as the executive branch. This means the corporate tax cuts, and their ongoing demand stimuli as well as their still-to-be-felt supply-side impact, are solidly in place for the next two years. At the same time, the president will be relatively free to continue his growth-supporting deregulatory agenda, an executive branch prerogative. Although it is too early to begin calling the 2020 election, the expansion of the Senate Republican majority and the less-than-anticipated loss of Republican governorships—especially in key presidential swing states Florida, Georgia (where they have yet to officially call the race) and bellwether Ohio (which no successful GOP presidential candidates has ever lost)—the odds of President Trump's re-election arguably just went up. To be sure, this enthusiasm is tempered by the loss of Republican governorships in two blue-collar industrial states Trump won in 2016, Michigan and Wisconsin. Still, the overall results among states should be enough to give investors' additional confidence that the corporate tax cuts are here to stay.
- **The perceived threat to inflation and the bond market of an unexpected Republican sweep has passed.** Although we were not buyers of the idea that a Republican sweep would be bad for bonds, in general bond investors have been nervously trying to discount the possibility that a Republican sweep could lead to additional deficit-producing spending and/or tax cut proposals. They can now breathe a sigh of relief. This morning, bonds are rallying and the dollar is heading lower, all good for stocks. And with the election behind him, the president is likely to ease up on his public attacks on the Fed, smoothing the path for policymakers to begin transitioning to a less restrictive stance. Fed/interest rate risk will now be largely a data-dependent issue, and if we are right that inflationary pressures will remain restrained, we anticipate the next big move for the Fed will be to drop its policy guidance ("dots") for the last two hikes in late 2019 and early 2020 that would bring the fed funds rate above 3% and potentially invert the yield curve. Good for stocks.
- **Major policy uncertainty risk for stocks has now been lifted.** One reason midterm elections often produce negative stock returns leading into them, and positive stock returns in the 12 months following them, is that investors do not like policy uncertainty and have to discount forward stock earnings at a higher rate to account for this. We've seen this effect in spades over the last couple of months, with stock market P/E multiples dropping a full point or more. With this major uncertainty now removed, markets can breathe a sigh of relief. And given the congressional gridlock now in place, little additional risk of a negative legislative development needs to be priced in. Call it "legislative policy Goldilocks."

For sure, the markets still have other milestones to get through to move to new highs and our longer-term targets of 3,100 and, eventually, 3,500 on the S&P 500. The China trade war and the Fed are first among these. As noted above, the Fed can now move back to "data-dependent" mode and out of "defend the institution from Trump" mode, so time will tell—but net net, the news flow from the central bank should become market supportive. China is more of a wild card, but with 2020 now just two years away, and the presidential election cycle soon to start, Trump needs at least a truce with China to remove the short-term negative impacts that the third-quarter earnings season began revealing. With President Xi also in need of getting China back to work, our guess is a positive development here over the next few months is likely. Smart leaders—and rest assured both of these leaders fit that category—have a way of finding the path they need to find.

Another potential risk: an unexpected negative turn of Robert Mueller's nearly 2-year-long investigation of all things Trump. He's gone radio silent due to the midterms, but now, if he has something, he's likely to bring it forward—especially with a supportive Democratic-controlled House that is seeking things to further investigate. Our own view is that there is really nothing here, but only time will tell.

So, we're not all clear yet, but having survived the worst possible tail events from these midterms, stock-market

investors have cause for a relief rally at least. And maybe even something more.

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