Weekly Update: Amen! The midterm election is over and we can get to work

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This week, I spoke in Austin, Texas, at my fifth annual meeting of several hundred financial advisors. It was after the election, and the tone of their questions was one of concern. But markets tend to like gridlock and divided government for the increased certainty and fiscal continuity that it provides. It typically doesn't allow for the accomplishment of much more on the policy side, making this year's corporate tax cuts almost impossible to roll back. Indeed, with the House and Senate now polarized more than ever, it seems very improbable anything substantive occurs in the next two years, with budget battles of old (including shutdowns) likely to return. President Trump should be relatively free to move by executive order on deregulation and other policy issues that a Democratic House is unlikely to act on. But if House Dems can put aside differences with and anger over Trump, it's possible there could be a constructive if limited relationship as there was between President Clinton and Newt Gingrich, the former Republican House speaker who flipped the House in 1994 with his "Contract for America'' initiative. (Although I'm not holding my breath.) Tuesday's outcome adds to seasonality factors already favoring equities. Historically, Q4 S&P 500 returns are the strongest of the year and even more so in midterm election years. Also, Wall Street sentiment remains beaten down at levels that historically have preceded solid S&P gains. And finally, one of the worst Octobers of the post-World War II era raises the potential for mean reversion through year-end. Last month's sell-off reinforces the view that systematic investing and electronic liquidity provisions can yield any price outcome regardless of fundamentals. All that's needed is a catalyst: this year, it was politics.

Since 1928, stocks have racked up average annual returns of 12% in years in which a Republican held the White House and Congress was mixed (red House/blue Senate, red Senate/blue House). At the sector level, potential for bipartisan support of a modest infrastructure bill could lift industrials and materials. A lot depends on the economy, of course, and there the picture is mixed. Globally, growth has slowed (*more below*), although recent readings have stabilized in China where authorities continue to add stimulus. In the U.S., growth remains firm. A few interest-rate sensitive sectors are showing signs of softness, led by housing, where higher mortgage rates have cut into starts, causing residential investment to subtract from GDP growth so far this year. But it's unlikely mortgage rates will continue to rise at the same pace, so that negative may start to weaken. Capital expenditure intentions and durable orders also have been slipping recently, suggesting corporations may be reining in investment plans due to global uncertainties. But these signs point to slower growth, not recession, with the U.S. likely to continue to grow above trend. Earnings have been strong. With the Q3 season winding down, 85% of the companies representing more than 80% of S&P market cap managed to meet or beat bottom line consensus forecasts, versus the historical average of 77%. Among S&P companies that have reported, year-over-year earnings increased by 25% on 9% revenue growth, surpassing the consensus forecast of 18.5% before the start of season and marking the third straight quarter of 20%+ earnings growth. The big problem with Q3 was guidance, with tariffs and China front and center, making the meeting in a few weeks between Presidents Trump and Xi critical (*we'll have more on this next week*).

Outside of Mitt Romney in Utah, the incoming Senate GOP freshman class will owe their wins largely to Trump, who barnstormed tirelessly for them. As of this writing, a few races had yet to be called but the Senate appeared to closing in on a 55-45 majority, tying its biggest ever. Most of the House Republicans who lost their seats were in districts and/or states that Hillary Clinton won in 2016. It is hard to see how Trump's power among congressional Republicans will not be increased. History also suggests it was a good night for Trump. Over the last 21 midterm elections, the party in control of the White House lost an average of 30 seats in House and 4 in the Senate, and Trump is the first president since Nixon in 1970 to have a split decision like this (George W. Bush won House and Senate seats in 2002). Sure, the Senate map was the worst ever for Democrats, but there is little doubt that Trump helped to pick up seats in the Senate. If there is work to be done, it may help that this year's midterms will result in the most women in history serving in Congress. At this writing, at least 92 had won in the House and 10 had won in the Senate, joining 10 in the chamber for a total of 112—the most to serve in Congress at once in history. (The previous record was 107.) A University of California-Berkeley/University of Chicago study found female legislators bring back $49 million more for their districts on an annual basis than do male legislators. Women get things done, and you men know that.

Positives

- **U.S. services going strong** The Institute of Supply Management's (ISM) October survey of non-manufacturing activity posted its second highest reading since August 2005, while a separate services gauge by Markit rose strongly, the first increase in five months. When combined with its manufacturing survey, the composite ISM readings correspond to 3.1% annual GDP growth.

- **Consumers feeling good** The University of Michigan's monthly survey surprised with an above-consensus initial November reading that showed consumer confidence in the economy remains elevated and, for the year so far, at levels last seen in 2000. The survey included one day of polling after Tuesday's election.
- **U.S. recession watch** Philly Fed leading indexes for states and the U.S. suggest the economy should continue to expand at an above-trend but more moderate pace. The share of states expecting to expand was a healthy 90%, but that's still the smallest share since September 2010. And the U.S. component of the monthly survey rose at its slowest pace in a year.

Negatives

- **Signs of price pressures** October producer prices rose the most in six years, driven by higher gas and industrial supply prices and increases in so-called trade service costs that track changes in the value of services provided by retailers and wholesalers. Elsewhere, the Labor Department’s quits rate—the rate at which confident workers leave jobs on expectations they can get better work elsewhere—remained at a 17-year high, a level Fed Chair Jerome Powell regards as a precursor of wage pressures. Job openings continue to outnumber available workers, further adding to these pressures as companies struggle to find and keep skilled workers.
- **Global recession watch** Global manufacturing grew at its slowest rate in two years, and indicators suggest conditions are worsening. Developed markets continue to outperform emerging markets, but both peaked almost a year ago, Markit surveys showed. Notably, global export orders contracted a second straight month, with just over half of countries reporting export growth—findings historically in line with global recessions.
- **Fed stays on rate-hike path** No surprises in this week’s post-meeting Fed statement beyond acknowledgment that business spending has moderated since policymakers last met. The narrative reinforced the view of a strong domestic economy that makes a December hike a near certainty, the only unknown being whether there will be two or three hikes next year. The futures say two; the dot plot says three.

What else

This and that election wrap The estimated 114 million votes cast in the House shattered 2014’s turnout of 83 million and was historic for a midterm … Tuesday marked the fourth straight midterm (2006, 2010, 2014, 2018) with at least one chamber of Congress flipping, the first time this has happened since right after World War II … For the first time since the 1970s, two congressmen under criminal indictment—GOP Reps. Chris Collins (N.Y.) and Duncan Hunter (Calif.)—won re-election … BCA Research doesn’t think the midterms impacted Trump’s 2020 chances one way or the other.

Don’t break out the champagne just yet Despite a post-election bounce, market breadth and volume is still short of thresholds that tend to accompany acceleration out of corrective phases. Daily stock trading indicators are nearing overbought territory, a sign of a potential interim peak, as the S&P moves toward resistance between its 200-day and 50-day moving averages. The big test may come around the 50-day average at 2,834 and the Oct. 4 breakdown point at 2,862.

Surely, something bad is already priced in! 2018’s forward P/E multiple contraction (from 18.2 to 15.5) is the third worst in 40 years. If history is a guide, this should lead to strong future returns, as typically is the case when the ISM composite reading is running above average, as it is now. If the S&P closes up on the year, it would be its 10th straight positive year, its longest up streak since 1926.

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Gross Domestic Product (GDP) is a broad measure of the economy that measures the retail value of goods and services produced in a country.

Price-earnings multiples (P/E) reflect the ratio of stock prices to per-share common earnings. The lower the number, the lower the price of stocks relative to earnings.

S&P 500 Index: An unmanaged capitalization-weighted index of 500 stocks designated to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Indexes are unmanaged and investments cannot be made in an index.

The Federal Reserve Bank of Philadelphia produces a monthly leading index that gauges economic activity in all 50 states.

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