

The midterm verdict is in

U.S. voters have opted for divided government. For Wall Street, not all longer-term implications are benign.

From a market perspective, it was probably the best outcome one could reasonably hope for. Votes for the U.S. 2018 midterm elections continue to be counted, however, it already appears clear that Republicans will see their majority in the Senate increase. Meanwhile, Democrats appear to have won a fairly comfortable majority in the House of Representatives. Democrats also recaptured at least seven governorships, including such deeply red¹ states as Kansas.² All of which is broadly in line with national polling trends and other data over the last couple of months.

Indeed, for all the nail-biting close races throughout election night, there were only a few genuine surprises. These included narrow Republican victories in the Florida governor and Senate races, as well as a couple of unexpected Democratic victories in heavily Republican House districts. Market reactions have been muted, except for a short period of dollar strength when it briefly looked as if Republicans might be able to hold on to the House.

A Republican sweep would more than likely have immediately given rise to market speculation on more deficit-financed tax cuts, leading to a stronger dollar and higher Treasury yields. While possibly helpful for U.S. equities in the short term, it would probably have increased the risks of the economy overheating and put additional strain on emerging markets. Conversely, Democratic victories in key Senate and gubernatorial races would have increased pressure on Congressional leaders to do more than just act as a check on President Trump. Sooner or later, impeachment would have been on the agenda, with all the uncertainty such a process would entail.

So, all is well that ends well? Yes, we would argue, as far as the health of the democratic process in the United States is concerned. For all hand-wringing and the newspaper ink spilled by political commentators, the combined results from both 2016 and 2018 show America's famed checks and balances working pretty well.

Back in 2016, President Trump was able to win a fairly unlikely victory in the Electoral College, despite lagging Hillary Clinton in the popular vote by some 2.8 million.³ The perceived unlikelihood of a Trump victory may explain much of the Republican success in holding on to both Houses of Congress in 2016, as well as the Democratic swing in the House in 2018. At least 15 out of the approximately 35 House seats Democrats gained on Tuesday were in House districts Clinton had carried. In those districts, voters had probably intended their Republican representatives to act as a check on Clinton, not as willing helpers for President Trump's

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¹Red is the color of the Republican party.

²At the time of writing, they were also still at risk of losing the Connecticut governor race. Counting was continuing in Alaska, while in Georgia, it remained unclear if the Republican candidate would be able to avoid a run-off by winning more than 50% vote.

³<http://time.com/4608555/hillary-clinton-popular-vote-final/>

agenda. At the first possible opportunity, these districts instead opted for a Democrat.

With the benefit of hindsight, the 2016 Republican sweep in Congress looks like a bit of a fluke. Despite Democrats' 2018 successes, however, investors would be ill-advised to start thinking of Trumpism as a temporary aberration. Donald Trump was able to win the Republican nomination by embracing a decidedly unorthodox and unabashedly nativist approach. Except for his trade conflicts, President Trump has largely governed like a traditional Republican during his first two years in office. That is not, however, how he ran in 2016, nor how he campaigned in 2018. Instead of, say, stressing the strong economy, promising entitlement reform or touting tax cuts, he successfully tried to make immigration a key issue. Politically, this was probably smart, given how unpopular any cuts to social security, Medicaid and Medicare would prove and given how unusually unpopular the Republican tax cuts have already proven.⁴

Health care and perceptions of the Republican tax cuts favoring the rich were probably instrumental in driving up turn-out among Democratic sympathizers. President Trump's divisive rhetoric helped Republicans get much of their base mobilized, too. The results were turnout levels, which appear closer to past presidential races than recent midterms.⁵

For American democracy, this is a healthy, if hardly unexpected, sign. Over the past ten years, there has been plenty of grass-roots activity on both sides. Such civic organization is at the root of the robust strength of American society and democracy. "When Americans have a feeling or idea they wish to bring to the world's attention, they immediately seek out others who share that feeling or idea and, if successful in finding them, join forces," was how Alexis de Tocqueville described this more than 170 years before the Tea Party (opposed to government overreach under President Obama) and the more recent March for Our Lives movement (in favor of stricter gun regulation).⁶ "From that point on, they cease to be isolated individuals and become a power to be reckoned with, whose actions serve as an example; a power that speaks, and to which people listen."

Well, American voters have now spoken twice. In 2016, Trump galvanized voters long frustrated by the sorts of policies, from free trade to immigration reform, which many in his party used to champion. That, in turn, helped mobilize Democratic voters in 2018. Democrats ran largely on promising to defend or even further extend the social safety net, notably by expanding health care. They appear to have made quite a bit of progress in state-level elections.

This should leave them better positioned ahead of the next round of redistricting after the 2020 census. By the 2022 midterms, redistricting is likely to significantly reduce the advantage Republicans have enjoyed in the House thanks to aggressive

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⁴For some data, see: <https://www.vox.com/policy-and-politics/2018/6/22/17492468/republican-tax-cut-law-poll> ; <https://fivethirtyeight.com/features/the-gop-tax-cuts-are-even-more-unpopular-than-past-tax-hikes/>

⁵<http://time.com/5447210/2018-voter-turnout/>

⁶Alexis de Tocqueville (2004 ed.), *Democracy in America*, translated by Arthur Goldhamer, The Library of America, pp. 598 (Vol. 2., Part 2, Ch. 5)

All articles are available on <https://go.dws.com/cio-view-articles>

gerrymandering following the 2010 census.⁷ Of course, Democrats are still likely to experience some electoral disadvantages. Many of their voters tend to cluster in cities and along the coasts. The Senate and to a lesser extent the Electoral College favor smaller, rural states by design. (see [CIO Special - Our U.S. election watch](#) as of 9/19/16)

However, the proper (and probably only workable) solution to this is not to reform or abolish the Senate or the Electoral College. Instead, it is to nominate candidates who can win over rural voters or expand the electorate by increasing turn-out. This has been the approach of Democratic Senate candidate Beto O'Rourke, and gubernatorial candidates Stacey Abrams and Andrew Gillum. All three got tantalizingly close to winning in their respective states, Texas, Georgia and Florida – states Trump carried in 2016.

Over the next two years, much will depend on how policymakers and markets interpret the 2018 results. Perhaps, President Trump will tone down his rhetoric. Bipartisan compromises appear possible, notably on infrastructure. Given the typical time lags of such projects, however, it is unlikely that such measures will have much of an impact before 2020. Nor would such deficit measures be particularly helpful at this stage of the economic cycle when the U.S. economy is already operating at or perhaps even slightly above full employment.

For the longer term, however, it is hard to overstate the investment implications of the last two U.S. elections. The main one is that Trump's core supporters, whom he affectionately calls "deplorables," will no longer be ignored. How long they will stick with Trump – or any Republican – remains to be seen. What is already clear, however, is that this is unlikely to ever again be a reliable constituency for free trade and entitlement reforms – the kind of policies, in other words, that corporate America and Wall Street might favor.

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⁷For details, see: <http://www.ncsl.org/research/redistricting/election-dates-for-legislators-governors-who-will-do-redistricting.aspx>
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Glossary

Democratic Party (Democrats)

The **Democratic Party (Democrats)** is one of the two political parties in the United States. It is generally to the left of its main rival, the Republican Party.

Electoral College

The **Electoral College** is the body which elects the President and the Vice President of the United States. It is composed of electors from each state equal to that state's representation in Congress.

Emerging markets (EM)

Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

Gerrymandering

Gerrymandering refers to the deliberate creation of voting districts in order to maximize the electoral advantage of one of the parties.

House of Representatives

The United States **House of Representatives** is a legislative chamber consisting of 435 Representatives, as well as non-voting delegates from Washington, D.C. and U.S. territories. Representatives are elected for two-year terms and each state's representation is based on population as measured in the previous Census.

Medicaid

Medicaid is an assistance program providing health coverage to people with low income. It is run by state and local governments within federal guidelines.

Medicare

Medicare is the U.S. national health insurance program for people aged 65 and above and younger people with disabilities or kidney failure.

Republicans

The **Republican Party (Republicans)**, also referred to as Grand Old Party (GOP), is one of the two major political parties in the United States. It is generally to the right of its main rival, the Democratic Party.

Treasuries

Treasuries are fixed-interest U.S. government debt securities with different maturities: Treasury bills (1 year maximum), Treasury notes (2 to 10 years), Treasury bonds (20 to 30 years) and Treasury Inflation Protected Securities (TIPS) (5, 10 and 30 years).

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United States Congress

The **United States Congress** is the legislature of the federal government. It is comprised of the Senate and the House of Representatives, consisting of 435 Representatives and 100 Senators.

United States Senate

The **United States Senate** is a legislative chamber consisting of 100 Senators, with each state being represented by two Senators. Senators are elected for six year, overlapping terms in their respective state.

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