U.S. MIDTERM ANALYSIS

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Northern Trust
Global Asset Allocation

James D. McDonald
Chief Investment Strategist
jxm8@ntrs.com

Daniel J. Phillips, CFA
Director, Asset Allocation Strategy
dp61@ntrs.com

Thomas J. O'Shea
Senior Investment Analyst
tjo3@ntrs.com

The election outcome was broadly in-line with our expectations and doesn't change our fundamental outlook on the economy or markets.

This was no typical U.S. midterm election, as voter interest hit record levels — certainly catalyzed by high levels of campaigning and increasingly polarized parties. As an example of heightened engagement, early voting by younger voters appears to have surged from 850,000 early voters under the age of 30 in the 2014 midterm cycle to more than 2.3 million this election. Going back to 1930, the incumbent party has lost a median of 30 seats in the House of Representatives in the midterm, so the Democratic gains have precedent but the magnitude of the eventual seats gained is still being determined. The Republicans have increased their slim majority in the Senate, giving them some breathing room on contentious issues going forward. Finally, the Democrats picked up at least eight state governors.

The finalization of the vote tallies won't change the primary outcome of the election at the federal level — change in control of the House to the Democrats. Our view that the election is unlikely to be a major market or economic event was based on an expectation of very limited legislative achievement over the next couple of years. This outcome increases those odds, as the House and Senate will struggle to find common ground on items of major significance such as taxes, infrastructure or health care. Leadership of the House committees switching over to the Democrats transfers oversight and investigative powers, but careful political calculation will be required to avoid overreach. Republican Senate control will facilitate the continued approval of federal judges that are central to the Republican agenda. Importantly, the election may have little impact on reducing U.S./China trade tensions as President Donald Trump's administration is leading this charge and Congress has shown little interest in intervening.

EXHIBIT 1: TOP LEVEL GAINS AS EXPECTED

Final vote tallies are required to see how close the Democratic gains were to expectations.

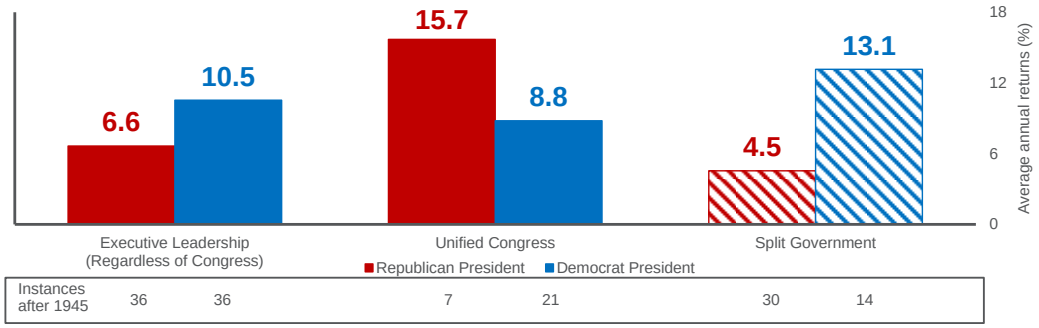
	HOUSE			SENATE			GOVERNORS		
	Pre-election	Expectation	Result	Pre-election	Expectation	Result	Pre-election	Expectation	Result
Democrat	193	**234**	**220**	49	48	45	16	24	23
Republican	**235**	201	196	**51**	**52**	**52**	**33**	**26**	**25**
Independent/Vacant/Undecided	7	n.a.	19	n.a.	n.a.	3	1	n.a.	2
# needed for control	218			51			n.a.		

Source: Northern Trust Investment Strategy, Expectation data from FiveThirtyEight on 11/6/2018. Result from Real Clear Politics on 11/7/2018.

All in all, we expect the outlook for the markets to be much more dependent on the growth and inflation outlook over the next couple of years than on political developments. With this report focusing on the election and its implications, we look to history for some clues about prior market performance in this environment. As shown in Exhibit 2, the best market returns since 1946 have occurred with a Republican president and unified Republican Congress (although this only existed for seven of the 72 years, so its statistical significance isn't high). Conversely, a Republican president in a split government situation (either split Congress or Democratic Congress) has generated the lowest returns. This is also true when looking at the results of the current election — a Republican president with a split Congress has generated the lowest returns of any of the possible combinations over this period.

EXHIBIT 2: GRIDLOCK ISN'T GOLDEN

Market returns during split government are mixed.

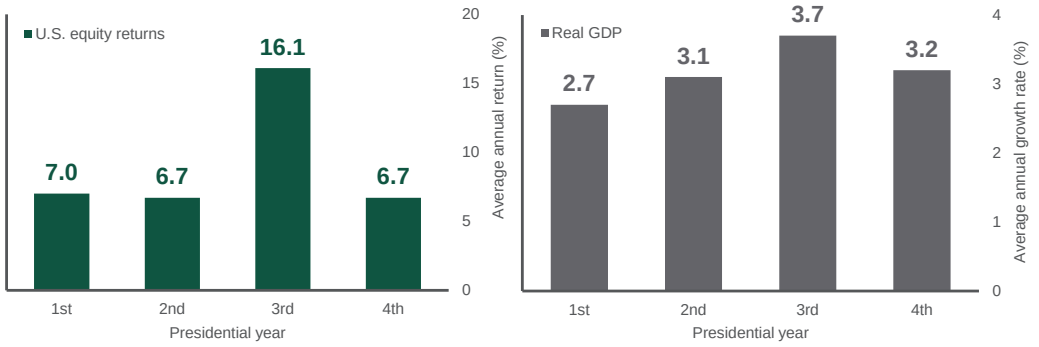


Source: Northern Trust Investment Strategy, Split Government refers to Republican (Democrat) President with Democrat (Republican) controlled or split Congress. Historical data shows S&P 500 price returns for calendar years1946 through 2017.

Another favorite of market historians is the presidential cycle, which has shown the historical pattern of the economic growth and market returns during a president's term. Typically, economic growth and market returns have peaked in the third year of the cycle, with the theory being that presidents try to boost growth to bolster their re-election prospects. This cycle, however, is setting up to be different. Economically, we think growth has peaked in the second year of the cycle (2018) due to the stimulative effect of tax reform. This also may have front-ended the stock market returns, which the 22% total return of the S&P 500 Index in the first year of the cycle may demonstrate. As we expect growth to slow in the third year, we wouldn't expect the typical cycle of market returns to repeat.

EXHIBIT 3: THIRD YEAR'S BEEN THE CHARM

Slowing growth in 2019 may upend the historical patterns.



Source: Northern Trust Investment Strategy, Crandall, Pierce & Company, S&P, Bureau of Economic Analysis.

Finally, we present the views of our equity research department (first presented in our Midterm Exam report on October 24) about the expected impact of the election on the outlook for the various sectors of the economy and stock market. In her election night speech, House Minority Leader Nancy Pelosi stressed three Democratic priorities: drug price controls, infrastructure and campaign finance reform. The latter two are routine political promises that never seem to go anywhere, while drug price controls may find an interested president but a skeptical Congress.

EXHIBIT 4: 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