



November 21, 2022

U.S. midterm elections: The return of divided government

By Angelo Katsoras

The Republicans have significantly underperformed expectations. This is first and foremost demonstrated by Democrats retaining control of the Senate. Democrats now control 50 seats to 49. Even if Republicans win the remaining Senate runoff election in Georgia on December 6, Vice President Kamala Harris will be able to cast a tie-breaking vote.

The GOP also won many fewer seats than expected in the House of Representatives. But they still will have control of a slim majority of this chamber in the next session of Congress that takes office in January. (221 seats versus 214 for the Democrats).

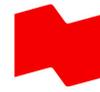
The following bullets explain how the shift from unified to divided government will constrain the Biden administration's ability to move its agenda forward.

- Barring a national emergency, major new spending initiatives involving such areas as tax hikes or new social policies are less likely to materialize over the next two years. The Republicans will not want to give Democrats any major legislative victories, especially going into the 2024 presidential election.
- The Biden administration will be forced in large part to advance its agenda via executive order, which allows presidents to make certain policy moves outside of the regular lawmaking process.
- Divided government means investors will spend more time focusing on who heads key regulatory agencies and less time on bills that often will have no chance of becoming law. The heads of regulatory agencies can, among other things, decide which regulations should be more stringently enforced.
- Just as the Democrats did during the Trump era, the Republicans will respond by challenging the legality of some executive orders and regulatory moves in federal circuit courts. Investors can make a reasonable guess as to how the courts will rule based on whether the majority of the presiding judges were appointed by a Republican or a Democratic administration.
- The Republicans will use their control of the House to investigate several of the administration's policies, including the chaotic withdrawal from Afghanistan and immigration. They could also investigate the business activities of Hunter Biden, the President's son.
- Debt ceiling worries will once again prove to be a false alarm. The debt ceiling has been raised or adjusted 28 times since 1993. While this has for the most part been routinely approved by Congress, there were disputes in 1995, 2011 and 2013 that led to government shutdowns. The United States is projected to hit its existing debt ceiling sometime in the fall of 2023. While disagreements could lead to another shutdown, the situation will likely be resolved well before the risk of defaulting on the debt materializes.¹ Democrats may try also to lift the debt ceiling before the new Congress officially takes over in January.

However, there are exceptions where bipartisan cooperation will still be possible:

- Taking a tough line on China is one of the few areas where there is overwhelming bipartisan agreement. Most recent legislation sanctioning China or helping U.S. companies compete against their Chinese counterparts has passed with strong bipartisan majorities. This will make companies with large investments in China increasingly nervous about being the target of Congressional scrutiny.
- The war in Ukraine, along with the increased tensions with Russia, should lead to a bipartisan agreement to increase defence spending. While there are more divisions among Republicans than Democrats regarding further aid to Ukraine, we feel there still remains sufficient bipartisan support for further military aid packages.

¹ "An Investor's Guide to the Looming Debt-Ceiling Fight," Washington Post, October 28, 2022



Conclusion

In the past, compromises have been possible under divided government in Washington, including for the passage of major tax and Social Security legislation under President Ronald Reagan and balanced budget measures under President Bill Clinton. However, reaching such compromises has become much more difficult in the current political environment. Indeed, as underscored in a recent New York Times article: "Today's political atmosphere is radically more polarized than it was in the 1980s and 1990s, making it harder to imagine a Democratic president and Republican Legislature coming together on areas of major disagreement except in a national crisis."²

Bonds could also be marginally boosted by a divided government which is less likely to approve significant new spending. A more restrictive fiscal policy could also weigh on U.S. economic growth for the next two years.

Finally, while stocks have performed better in the six months after the election than they did in the six months prior in 17 of the 19 midterms held since 1946,³ this time around the results may be of lesser consequence than the evolution of inflation, monetary policy, the war in Ukraine and China-U.S. tensions.

² "Biden's Agenda Hangs in the Balance if Republicans Take Congress," New York Times, October 29, 2022

³ "Politics and your portfolio: Midterm elections create uncertainty for markets," CNBC, October 31, 2022



Economics and Strategy

Montreal Office

514-879-2529

Stéfane Marion

Chief Economist and Strategist
stefane.marion@nbc.ca

Kyle Dahms

Economist
kyle.dahms@nbc.ca

Alexandra Ducharme

Economist
alexandra.ducharme@nbc.ca

Matthieu Arseneau

Deputy Chief Economist
matthieu.arseneau@nbc.ca

Daren King, CFA

Economist
daren.king@nbc.ca

Angelo Katsoras

Geopolitical Analyst
angelo.katsoras@nbc.ca

Jocelyn Paquet

Economist
jocelyn.paquet@nbc.ca

Toronto Office

416-869-8598

Warren Lovely

Chief Rates and Public Sector Strategist
warren.lovely@nbc.ca

Taylor Schleich

Rates Strategist
taylor.schleich@nbc.ca

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.



UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 70 St. Mary Axe, London, EC3A 8BE.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.

This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.