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Investment Institute

FIRST ANALYSIS

Institute Alert

News or events that may affect your investments **November 9, 2022**

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First impressions on the post-midterm landscape

Key takeaways

- As of the pre-dawn hours on November 9, the outcome of the 2022 midterm elections is still open. Control of the U.S. House of Representatives in the next Congress leans towards the Republicans but is not yet determined. Control of the U.S. Senate control depends on results still to be tallied.
- Completing the fiscal 2023 budget and raising the debt ceiling are the main issues in the balance for the 117th Congress. A new Congress in 2023 may bring new leadership and priorities, but we do not expect large new spending or tax initiatives.

What it may mean for investors

- The economy's performance and the Federal Reserve's (Fed's) policies to shape its path are likely to matter more than the election results to investment returns, in our view. This greater importance of the economy and Fed policy remains the focus of our guidance.

A lame duck's race against time

As votes remain to be counted, and investors woke up on November 9 with the House and Senate still too close to call, we view the 2022 midterm elections shaping lame-duck themes during the balance of the year in this way:

The budget heads the lame-duck to-do list, topped by a bill to fund fiscal-year 2023 spending beyond September's continuing resolution, which extended the budget until December 16. We expect a 2023 budget compromise that increases defense outlays, in exchange for some combination of increased spending on water resources, flood insurance, energy-permitting reform, and aid for COVID-19 and monkeypox. Such an agreement should be enough to avoid a deadlock in budget talks and a politically damaging government shutdown.

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In a nearly evenly divided Congress, there may be more smoke than fire surrounding talk of a reconciliation bill or other legislation to supplement the climate and medical care spending included in this year's Inflation Reduction Act. Those provisions likely would face continued opposition from Democratic moderates and more general pushback from legislators who worry that wider budget deficits may aggravate inflation. This opposition should be enough to make an inherently complex reconciliation process all but infeasible during the two-month lame duck.

The lame-duck **tax debate** could center on Democratic revival of the child tax credit, perhaps accepted by Republicans as a quid pro quo for extended research and development (R&D) tax expensing.[1] Threatened corporate, capital gains, and upper-income tax increases likely will fade, along with the supplemental Inflation Reduction Act spending that they would finance.

Some brinksmanship typically accompanies debates around extending the **debt ceiling**, but we view a lame-duck agreement as feasible. Congressional leaders in the new session may want to clear the decks — unilaterally, if there is one-party control of Congress, or through a two-party compromise if control is split — of this and other politically sensitive issues before the start of the 118th Congress.

Also likely to be addressed is the bipartisan **Secure Act 2.0 bill**, mentioned in our October *Policy, Politics & Portfolios* report, that would expand retirement-savings tax breaks, principally by loosening restrictions on required minimum distributions and by facilitating small-business sign ups. Also moving ahead in the Senate is a largely symbolic "NOPEC" bill, allowing the Justice Department to sue oil cartel members for antitrust violations in manipulating the supply, price, and distribution of oil and natural gas in the U.S.

Congressional horse trading on the horizon

Even if a single party controls both chambers, we expect partisan strategies to face high hurdles to become law. First, once all the votes are counted, we expect no filibuster-proof majority in the Senate. Second, any legislative agenda focused on economic issues likely will involve horse-trading in a Congress that lacks the two-thirds majority needed in each chamber to overturn a presidential veto. Third, as in the current Congress, any narrow majority likely will have to work hard to find compromises that hold the majority caucus together.

Split control of the federal government between Republicans and Democrats doesn't have to mean complete gridlock. A legislative logjam can be avoided by compromise on some issues and bipartisan support for others, leaving open the possibility of bills with important investment implications. Here's an early look at how we think next year's 118th Congress plays out:

Fiscal policy initiatives: Spending compromises not finalized during the lame-duck session easily could return in 2023. There is bipartisan support to increase defense spending. However, defense inevitably will be part of a larger debate over deficits and other non-defense discretionary spending, such as scaled-down additions to Build Back Better's health care, renewable energy, and hard and soft infrastructure programs favored by the Democrats. While inflation remains elevated, tax-and-spend packages are likely to be more difficult to push through in a nearly evenly divided Congress, especially for moderates facing election in 2024, who may not want to be blamed for spending if inflation returns.

Bipartisan issues: Prospects are brighter for those issues enjoying two-party support. Among them are a supplemental Chips and Science Act extending restrictions on China's access to U.S. semiconductors; credit-card reforms to enhance industry competition; and legislative support for regional infrastructure to boost near-shoring supply-chain opportunities. We view NOPEC and Secure 2.0 legislation as other likely candidates to become law in 2023 if they fail to pass in Congress' lame-duck session this year.

1. As described in our October Policy, Politics & Portfolios report, a provision of the 2017 Tax Cuts and Jobs Act allows companies to expense R&D spending on tax returns only through 2021. Unless Congress extends the provision, companies must return to capitalizing and amortizing R&D expenses over 5 to 15 years.

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For investors, it's the economy over politics

All national elections are important, and the partisan divide in the U.S. seems to focus national attention more keenly with every two-year cycle. Nonetheless, we expect that economic growth (or recession), inflation, and interest rates will matter far more to markets in 2023 than the 2022 election outcomes. The possibility of divided government further underscores our view that the economy will do the most to shape the market environment and that policy decisions in Washington may play a smaller, narrower role that matters more for particular sectors than for broad market outcomes.

Implications for investors

For these reasons, after the midterms, we prefer to focus on the economy that we believe is in transition to recession but likely shifting back to growth later in 2023 as inflation and interest rates retreat. Our guidance for long-term investors has been and remains to stay patient and to deploy available cash incrementally on high-quality asset classes and sectors. We favor the same quality perspective for shorter-term investors with a tactical (6 to 18-month horizon). Our preferences remain as follows:

Equities: Higher-quality, large- and mid-cap U.S. stocks operating in the less-cyclical Health Care sector; in Energy, on strong fundamentals and reasonable valuations; and in strategically attractive Information Technology.

Fixed income: As the market approaches a peak in Fed rate hikes and long-term yields, we favor a barbell approach, adding now to long- and short-term investment-grade allocations from cash or maturing intermediate-term fixed income.

Commodities: In July, our guidance added exposure above long-term allocations to a broad-based commodity allocation as a potential partial hedge against inflation.

Alternative investments: We favor positions in the Global Macro and Relative Value hedge fund strategies that can provide portfolio diversification.

Election-related considerations do not change any of our current sector preferences, but the legislative program of the new Congress bears watching for several sector-specific possible legislative packages:

Industrials: We currently rate the Industrials sector as neutral (hold at the sector's S&P 500 Index market weight). We anticipate an economic recession into mid-2023, but a counterbalancing positive would be a congressional extension of the R&D investment expensing provision. Within the Industrials sector, however, we favor overweighting the Defense industry, which stands to benefit from likely increased military spending in 2023.

Financials: Likewise, we favor allocating to the Financials sector at its market weight but want to watch for passage of the Secure 2.0 legislation for its potential to expand incentives for employer-sponsored retirement savings plans.

Information Technology (IT): We currently favor allocating to the Information Technology sector at above its market weight. IT potentially could benefit from additional defense spending, and from any extension of the R&D investment expensing provision in the tax code. Technology also could benefit from Secure 2.0-related investment by financial-services firms to boost capacity and to lower operating costs through computer upgrades.

Health Care: Earlier in 2022, the Inflation Reduction Act placed price controls on Medicare drugs. Gridlock in a split government won't reverse the drug-pricing controls, in our view, but a split government is unlikely to add more pricing restrictions.

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Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Sector investing** can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Alternative investments, such as hedge funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund's offering documents should be carefully reviewed prior to investing.

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