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WHAT DO THE MIDTERM ELECTION RESULTS MEAN FOR MARKETS?

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Overview: Highlights and implications of the midterm elections

What could the midterm election results mean for markets through year-end?

This year's midterm elections saw many tight congressional races, particularly in the battleground states of Arizona, Georgia, and Pennsylvania. Republicans won a narrow majority in the House, and Democrats retained control of the Senate. Down-ticket races at state and local levels also were mixed. We now look ahead to the 2023 legislative session.

Ahead of a House leadership change in January, we look for a very active lame-duck session given the brief window to pass legislative priorities. We expect that a fiscal year 2023 budget and spending bill alongside the debt ceiling will top the list, as the current continuing resolution ends on December 16. A busy lame-duck session could capture market attention as lawmakers horse-trade under a tight time frame.

In this month's report, we review our expectations for the lame-duck session, discuss likely executive and legislative priorities for the new Congress in 2023, and consider implications for the markets and investors.

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Recap: Expectations for the 2022 lame duck session[1]

Michael Taylor, CFA, Investment Strategy Analyst

With Republicans poised to hold a thin majority in the House next session, we anticipate this will likely influence the agenda and tone of legislative activity through year-end. Over the few weeks, we expect:

- *An active session.* We expect current congressional leaders to use the final days of their two-house majority to push their legislative priorities most likely off the table ahead of the divided control of the upcoming 118th Congress.
- *Compromise likely.* Spirited bargaining over time-sensitive budget issues for both parties likely will make headlines and we believe could contribute to market volatility in the balance of the year. As we point out in the next section, however, we believe investors should look beyond this legislative session and, instead, focus on the economy and Federal Reserve (Fed) policy.
- *Potential risk of legislative gridlock.* A fleeting two-house Democratic majority faces risks of Republican delay over key tax and spending legislation until Republican leadership can maximize leverage in the new Congress.

Some priorities for lawmakers that we anticipate in this year's lame-duck legislation include:

Fiscal year 2023 budget and appropriations — Next year's fiscal budget will top the lame-duck to-do list, to fund fiscal 2023 spending beyond the December 16 expiration of a continuing resolution. With a split Congress next session, we expect a 2022 compromise on the 2023 budget to increase 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. We expect that time pressure will overcome partisanship to pass a fiscal year 2023 budget.

We believe there is the possibility of a reconciliation bill or other legislation to supplement the climate, medical care, and miscellaneous spending items included in this year's Inflation Reduction Act. Those provisions likely would face continued opposition from Democratic moderates and general pushback from legislators who worry that larger budget deficits may aggravate inflation. Such opposition should be enough to make a complex reconciliation process impractical under a tight lame-duck time frame.

Tax reform — The lame-duck tax debate could center on Democratic revival of the child tax credit, a priority of the White House, perhaps accepted by Republicans as a trade-off for extended research and development tax expensing. We expect the threat of corporate, capital gains, and upper-income tax increases most likely will fade during the lame-duck session.

Debt ceiling — The debt-ceiling limit will also likely be addressed in the lame-duck session to avert gridlock and a potential government shutdown next year. Some brinksmanship typically accompanies debt-ceiling limit negotiations, but we view a lame-duck agreement as quite plausible. The new leadership may seek to resolve this and other politically sensitive issues before assuming control of Congress.

Summary

The lame-duck session is likely to accelerate the pace of activity in Congress. While we expect progress on a budget and the debt ceiling, more dramatic changes in tax and spending policy are unlikely. We favor keeping a focus on the economy into the end of the year. An impending economic recession, changes in inflation and Fed policy, and, ultimately, economic recovery are likely to dominate market movements as we look ahead to 2023.

1. For full details, see Wells Fargo Investment Institute (WFII) Alert "First Impressions on the Post-Midterm Landscape," November 9, 2022.

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Market implications of split government

Douglas Beath
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The history of midterm elections in the U.S. and the performance of the S&P 500 Index: Historically, over the past 60 years and 15 ensuing midterm elections, the best average returns have occurred in the 12 months following the midterm elections, while the worst average returns have been in the 12 months preceding the midterm elections. More specifically:

- During the 12 months leading up to midterm elections, the average annual return for the S&P 500 Index has been +0.3% versus the +8.1% historical average.
- During the 12 months after midterm elections, the S&P 500 Index has historically averaged a 16.3% gain.

Past performance is not a guarantee of future results.

In addition, the parties controlling Congress and whether they change after a midterm election historically has not an indicator of future economic growth.

A common explanation for the significant performance dichotomy around midterm elections is that markets do not like uncertainty, so once elections have been completed, businesses can make future plans more effectively as they now have a clearer picture of the tax and regulatory landscape. Seasonal trends could be another potential factor considering that November and December have ranked as the second-and third-best performing months of the year since 1950.

A potential roadblock that could break the string of gains for U.S. stocks following midterm elections is that we are forecasting a moderate recession into the middle of next year — which would be the first recession since 1929 to begin in the third year of a presidential cycle. A counterpoint that could favor stocks during this post-election period is that the significant underperformance versus the average midterm election year (S&P 500 Index: -20% year-to-date through November 7, 2022) potentially bodes well for future returns, as stocks have historically tended to rebound sharply over a market cycle of three to five years after significant declines. Such a pattern is consistent with our outlook for an economic recovery in mid-2023.

Implications of a divided government

The new 118th United States Congress will be sworn in on January 3, 2023, ushering in a divided government that we anticipate will make it harder to implement major spending initiatives or policy changes over the next two years. Equities have historically performed well in periods of divided government that is accurately labeled “gridlock.” Over the 75-year period ending in 2020, the average annual return for the Dow Jones Industrial Average was +8.3% versus +12.9% when Congress was split.

Finally, a divided government would be considered disinflationary by some investors, as additional fiscal stimulus on top of the recently passed Inflation Reduction Act may be difficult to implement.

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Despite extensive data on midterm elections and corresponding equity performance, long-term market movements have not been driven by elections but by fundamentals, such as profit margins, interest rates, and valuations.

The aforementioned above-average returns for U.S. large-cap stocks during periods of divided government exhibits a strong correlation, but does not indicate causation. Our conviction is that economic and stock market performance in 2023 should be determined by the macroeconomic environment, particularly as it relates to Fed policy — not on future policies of the newly elected, divided government.

On this point, our forecasts show the following:

- A moderate U.S. economic and earnings recession into mid-2023 due to the Fed's decision to pull forward rate hikes along with its plan to double the pace of balance-sheet reduction.
- Inflation slowing more quickly into the end of this year and into 2023, in line with expectations that the economy will slow at a faster pace.
- Year-end 2022 federal funds rate target of 4.25% to 4.50% (up from the current 3.75% to 4.00%), with expectations of a terminal rate of 4.50% to 4.75% by early next year; we then expect the Fed to pause and then aggressively cut rates to bring the federal funds rate down to a target of 3.50% to 3.75% by year-end 2023.

What it means for investors

We expect markets to establish a potentially wide trading range over the next few months as the magnitude and duration of the recession and its impacts become clearer. In our view, once investors begin to anticipate a mending economy, a recovery later in 2023 and into 2024 should send stock prices and price/earnings multiples higher even as earnings contract. We are looking for that opportunity to take more cyclical preferences, but for now, we continue to advocate defensive positioning in equities, favoring high-quality U.S. large-cap and mid-cap equities over small-cap equities and international equities.

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Post-midterm politics and the investor

Navigating change in the congressional balance of power

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More than just a gridlocked Congress?

Midterm election results have altered the political landscape in Washington, D.C. Republicans won the House, but by a small margin, while Democrats remain in control of the Senate with a Democratic president in the White House. The effectiveness of the 118th Congress taking office in early January 2023 will be shaped, to some extent, by the outcome of what could be an active lame-duck session immediately following the election. At first glance, it is easy to dismiss next year's lineup as a recipe for legislative gridlock, but we believe its record could be more nuanced than that.

First, there are the immediate demands of the fiscal 2023 budget and looming debt-ceiling constraints later next year if the two issues are not effectively addressed in this year's lame-duck session. This raises the possibility of considerable horse-trading between Democratic and Republican priorities to get legislation past the president's desk. Beyond that is bipartisan support for several pieces of legislation, whose investment implications are generally consistent with our strategy preferences. Yet another venue to potentially ease a legislative logjam is for the president to end-run Congress with executive mandates. The principal drawback of this method may be a lack of staying power often adding to unsettling flip-flops in financial markets.

For investors, the key is to keep election results in perspective. With few exceptions, investment performance is driven by economic growth, inflation, interest rates, and other market-related fundamentals. In our view, economic policies circumscribed by a split government make it even less likely that election results will materially shape the investment landscape in 2023.

Agreeing to agree

Immediately following the midterm elections, the economy and inflation should prove to be top concerns for both Republicans and Democrats as a recession draws near. Republicans' approach to mitigating ongoing price pressures has involved limiting significant increases in federal expenses and tax hikes. By contrast, Democrats have preferred to support the economy with increased spending and tax relief, by enhancing the child tax credit, improving health care coverage through Medicaid expansion, increasing funding of renewable energy, and implementing other social spending.

Contrasting tactics in a split government may incite heated debates, but we also see gridlock leading to possible areas of compromise. More generally, increasing deficits could limit future fiscal stimulus. The Congressional Budget Office (CBO) is projecting deficits averaging 5.1% of gross domestic product (GDP) in the coming decade from 3.3% in the decades before the pandemic. The CBO expects that rising interest rates, and associated interest expense, will widen the federal government's budget gaps in the coming years.

A federal deficit already set to average a historically high 5.1% in the next decade from a norm of 3.3% before the pandemic will likely constrain any proposal to boost spending in Congress next year.

Source: Congressional Budget Office, July 2022

Split governments arising from midterm election losses by the president's party have typically resulted in executive order increases ranging from 27% for President George W. Bush to 43% for President Obama during their last two years in office.

Source: The Federal Register, data as of October 28, 2022

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Republicans are almost certain to oppose Democrats' proposed plans to increase spending and taxes in our view.

Republican opposition to tax changes may potentially benefit domestic large-cap multinational companies, as we foresee the global minimum tax and tax hikes on multinational income having a low risk of implementation in 2023 and 2024. More generally, keeping tax rates at the current level would continue to support our most favorable rating on U.S. Large Cap Equities.

We see key sectors of the market affected by the new congressional lineup in this way:

1. We believe parts of the **Health Care** industry may potentially benefit if compromise legislation includes extensions of expiring Medicare and Medicaid programs. More generally, a split government can reduce the risk of added health care regulations. Regardless of the election outcome, drug-pricing controls included in this year's Inflation Reduction Act are expected to have limited impact on the pharmaceuticals and biotech industries, according to Wells Fargo Advisor's Global Securities Research Health Care analyst. A split government should decrease the risk of even more stringent measures enacted in the run-up to the new law's implementation in the mid-2020s. Beyond that, our current favorable view of Health Care is based on demographic tailwinds and its added tactical benefit — ahead of a recession — of being historically less economically sensitive than most other sectors.
2. Differences over **defense spending** should have less to do with the need for increased spending than with the geographical allocation of defense funds and the types of equipment to achieve regional goals. The Democrats favor continued aid for Ukraine, while some Republicans are inclined to tilt toward addressing geopolitical tensions in Asia. Support for increased defense spending should benefit the aerospace and defense industry, making up more than 20% of the overall Industrials sector. We have maintained a neutral rating there, which means that we favor holding market weight within the S&P 500 Index. We believe increased defense spending could reinforce support for the economically sensitive Industrials sector during a second-half recovery from our forecasted recession through mid-2023.
3. **Semiconductors** are positioned to potentially benefit in 2023 from bipartisan efforts to diversify production away from China. There is support from both sides of the aisle to protect U.S. technology and infrastructure, so we expect Congress to keep incentivizing domestic investment and build upon policies enacted in this year's Inflation Reduction Act and CHIPS and Science Act. We anticipate further progress in promoting U.S. chip production to benefit the Information Technology sector — particularly the semiconductor space — over the long term, and so we remain favorable on the group.

Key takeaways

- The risk of split government translating to legislative gridlock next year may apply less to important fiscal deadlines and to several issues with bipartisan support.
- We view the use of executive orders to achieve economic and regulatory goals as a poor substitute for legislative action since they have tended to be both narrow in scope and have been easily reversed by changes in party control of the White House.
- Investment implications of prospective legislative action are generally consistent with our portfolio guidance in stocks, bonds, and other assets.

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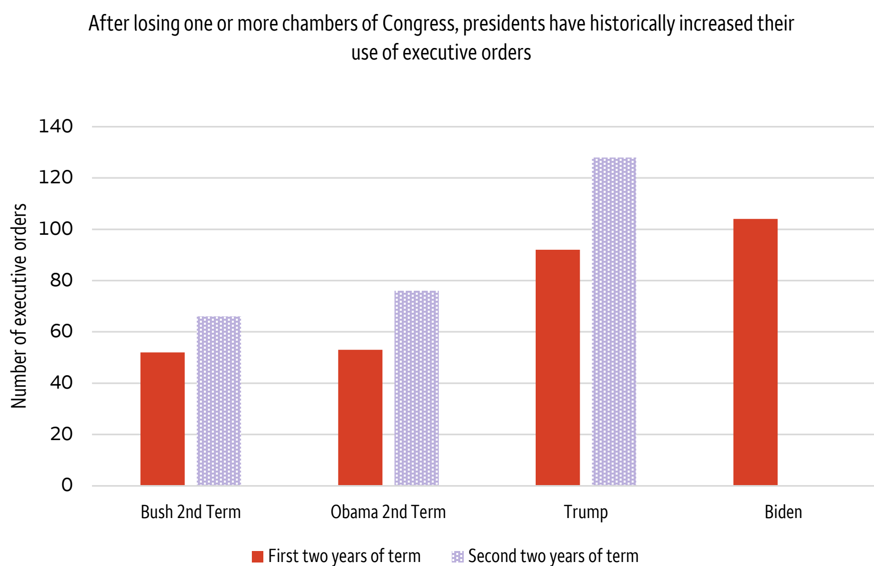
4. Lastly, we believe **Financial Services** stands to benefit from bipartisan support for Secure Act 2.0 legislation to expand incentives for employer-sponsored retirement savings plans. If the legislation is not resolved during the lame-duck session, we expect momentum to pick up in the new Congress in 2023.

We favor allocating to the Financials sector at its market weight but want to watch for passage of the Secure Act 2.0 legislation for its potential boost to investment management services.

Bracing for a wave of executive orders

The alternative to legislative action in a newly divided government could be a more frequent utilization of presidential executive actions. While executive orders may seem to offer a simpler path to enact policy, it is worth noting that they have been more easily overturned by incoming presidents and have been increasingly subject to judicial review. In fact, in the first 100 days of their terms, the past four presidents revoked nearly 40% of the executive orders from prior administrations, according to data from the American Presidency Project.[2]

As indicated in the chart below, increases in the number of executive orders after the midterm elections in the final term of a presidency ranged from almost 27% during the George W. Bush administration, to 40% during the Trump years to 43% in the final two years of the Obama presidency.[3] This rise is likely due to an increase in legislative gridlock accompanying the loss of one or both houses of Congress. We expect President Biden to continue this pattern, though we believe the focus likely will be more on issues like climate change and social policy, areas with historically less of a general market impact than fiscal policies and other economic issues.



Source: The Federal Register/Wells Fargo Investment Institute, October 28, 2022.

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2. The American Presidency Project, University of California at Santa Barbara.

3. The Federal Register and Wells Fargo Investment Institute, as of October 28, 2022.

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