



CIO Special

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U.S. Election: Midterm Matters

Key takeaways

01 Introduction

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- On November 8, votes will be cast to decide the 118th U.S. Congress. History shows that such midterm elections typically swing in favor of the opposition party, but America remains a deeply divided nation – potential surprises could occur.
- Republicans are campaigning on a platform of a faltering economy and record high inflation while Democrats are emboldened by implications of recent judicial action.
- Market performance during times of a Democratic Executive and a Republican Congress has typically been positive. However, macro tail risks remain on the table.

01 Introduction

Within global politics, there are very few nations that have a political calendar as demanding as the United States of America. Not only for the Presidential elections, which are held every four years, but also the 'Midterms', which are held every two years. Midterm elections involve races for both the House of Representatives and U.S. Senate, state governorships, as well as various other political positions. The political maneuvering, financing, and campaigning witnessed throughout, sometimes years before the election even takes place, ensures that this is a unique aspect of American society with often global consequences. This November, American voters will once again participate in this political phenomenon in what is often described as a "referendum" on the incumbent president.

Within this CIO Special, we look to outline the current political landscape for President Biden and the Democratic Party as well as their Republican opposition whilst also highlighting the key battleground states and the issues that are set to be voted on this November. We will also assess our own probabilities for how the U.S Congress could look once the votes have been cast, and more importantly, their implication on policy and investment markets.



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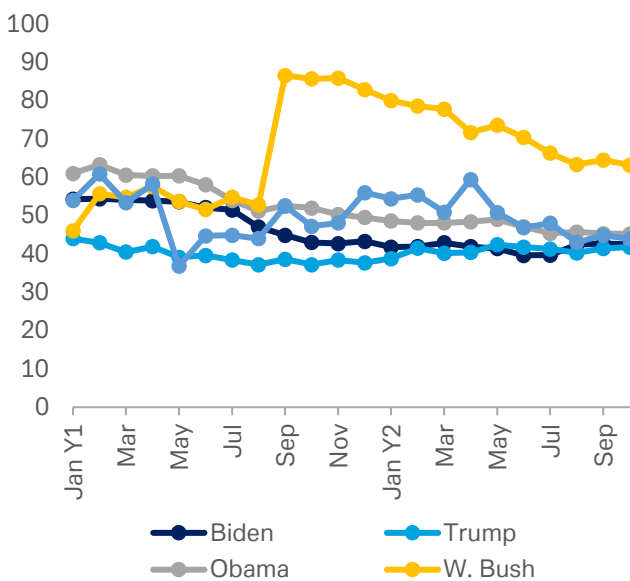


02 “A referendum on the Presidency”

It was once said that “elections are not a beauty contest; it is all about tolerance” and on November 8, President Biden and the Democratic Party will discover how much tolerance the American people have regarding their abilities to guide the country through the next two years as economic pressures continue to cast a shadow over the country. Historically speaking, the midterms are a challenging time for every President, with a common belief that they are simply a ‘referendum on the executive’. Regardless of economic landscape or political temperature within the country, only twice has the President’s party gained seats in both the Senate and the House: Franklin D. Roosevelt’s first midterm election and George W. Bush’s first midterm election – the latter of which being driven heavily by the events of September 11, 2001, and a more unified feeling across the country.

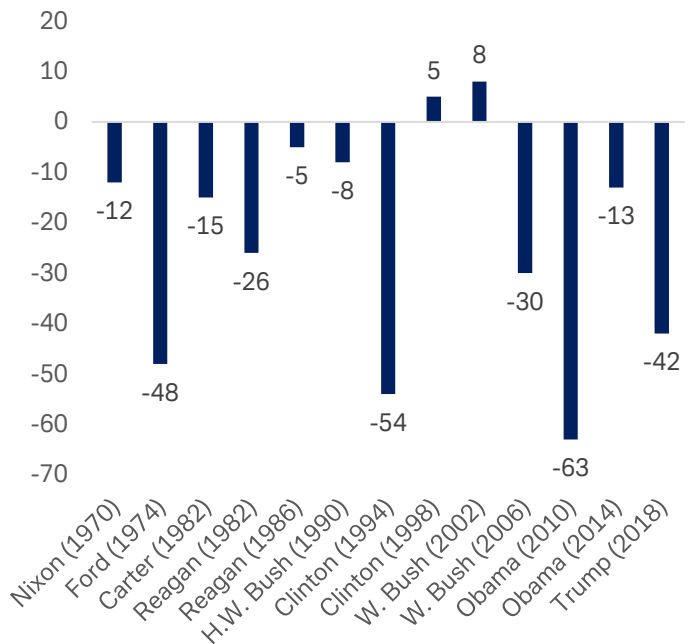
Such swings in both the House and Senate will clearly influence the Administration’s ability to deliver policy successes over the remainder of the President’s term. Such examples include President Obama’s infamous “shellacking” in 2010, where a record 69 seats were lost in total – essentially bringing his legislative agenda to a standstill against a newly crowned Republican House. Similar patterns had also occurred in 2018 for President Donald Trump, with the Democrats regaining control of the lower chamber. The results of the midterms typically occur as the President faces falling poll numbers in the build-up to the election. The difficult situation facing President Biden is that his poll numbers are amongst the weakest in modern times; only President Trump had a lower approval rating at this point of his Presidency.

Figure 1: Approval ratings prior to a President’s first midterm election



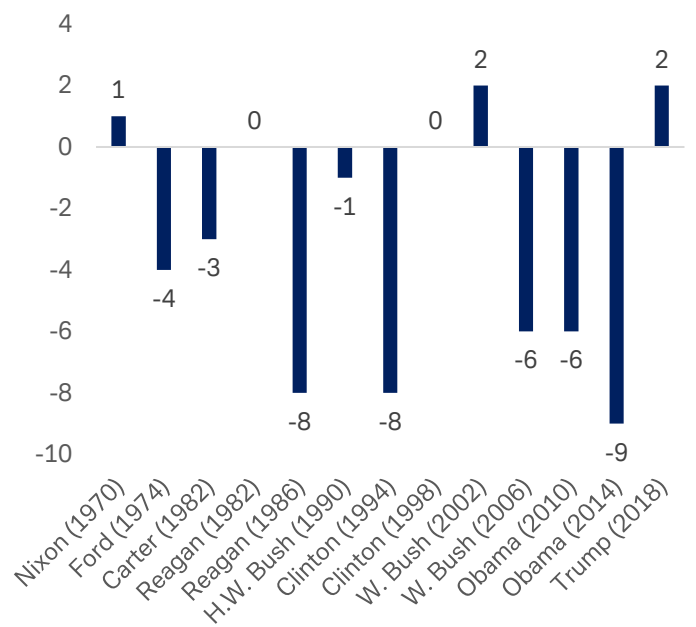
Source: FiveThirtyEight, Deutsche Bank AG. Data as of October 21, 2022.

Figure 2: Change in house seats by President’s party



Source: FiveThirtyEight, Deutsche Bank AG. Data as of October 21, 2022.

Figure 3: Change in senate seats by President’s party



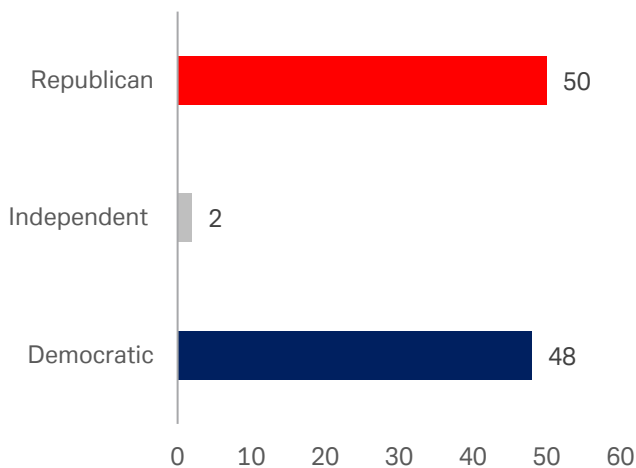
Source: FiveThirtyEight, Deutsche Bank AG. Data as of October 21, 2022.



The Biden Presidency so far has been one of tense negotiation and internal compromise. Mainly due to the composition of the U.S. Congress, which remains finely balanced. Following the 2020 election, the U.S. Senate consisted of 48 Democrats, alongside 2 Independent Senators on one side of the aisle with 50 Republican Senators residing on the opposite side. In the lower chamber, the House of Representatives, the numbers currently favor the Democrats by 11 but overall, the picture is clear to President Biden that every vote counts.

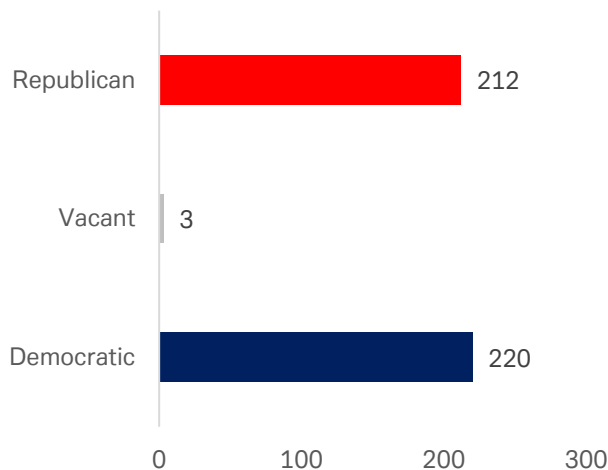
As things stand, the Republican Party needs to win an additional 4 seats in the House (assuming vacant seats remain in Republican control) whilst just 1 further Senate seat will be enough to secure a full majority in the U.S. Congress. This fine balance is further complicated by a record number of Democratic retirements (those not looking for re-election) amounting to 39 members of Congress – the highest since 1996.

Figure 4: U.S. Senate breakdown



Source: www.senate.gov, Deutsche Bank AG. Data as of October 21, 2022.

Figure 5: House of Rep. breakdown



Source: www.house.gov, Deutsche Bank AG. Data as of October 21, 2022.

As with many elections in modern times, there will be several key states to keep an eye on during campaigning. Ohio, North Carolina, Pennsylvania, and Georgia will remain vital for any victory in U.S. politics. In the U.S. Senate, there are 35 seats up for re-election: 21 Republican seats and 14 Democratic. Of these races the most competitive will be Nevada, Georgia, New Hampshire and Arizona. All five will be the key races in which Senate Democrats must defend their seats. For the Republican Party, several long-serving Senators are retiring from public service in what will be closely fought states. Such retirees include Senators Richard Burr (North Carolina), Pat Toomey (Pennsylvania), Rob Portman (Ohio) and Roy Blunt (Missouri).

03 Base Politics: The Economy v. Social Issues

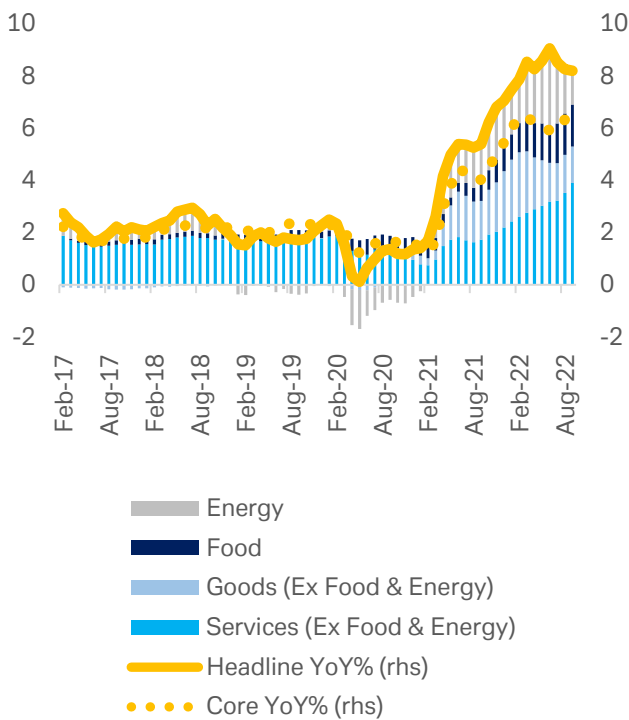
For both the Democrats and Republicans campaigning towards the midterms, there has been an evolving narrative that each party have gravitated towards in order to galvanize voters. For the Republicans, the strategy is clearly focused on the current state of the U.S economy which, historically speaking, is an issue that has seen Democrats come out on top with more recently at the polls; including President Clinton’s infamous “it’s the economy stupid!” campaign in 1992 as well as during President Obama’s first-term victory in 2008. This time around, record high inflation levels have been a thorn in the side of the Biden Presidency, which many Republicans have used to attack the current administration, citing their inability to control gas prices and further mishandling of Federal funds through stimulus checks directly into the pockets of Americans. The final Consumer Price Index (CPI) report ahead of the midterm elections showed inflation running at an annualized rate of 8.2%. Whilst certainly lower than the June peak of 9.1%, the broadening of price increases across housing, food and medical services will be a difficult message for the Democratic Party to overcome. For the Republican Party, the highest inflation levels in 40 years will certainly give candidates a stronger platform to campaign from.

More recently, Republicans have been focusing more on the U.S. housing market as the risks regarding affordability and mortgage payments climb up the list of voter concerns. The Federal Reserve’s response to rising inflation has so far seen steep moves in interest rates, causing mortgage rates to rise to levels not seen since the Great Financial Crisis of 2008. Currently the average rate for a 30-year fixed rate mortgage has increased to 7.32%, more than doubling since the beginning of the year when the average was 3.27%. Elsewhere, crime and public safety remains a key talking point for Republicans to focus on, linking the Democrats to the rise in violent crime over the course of the COVID-19 pandemic with certain narratives connecting the more “progressive” arm of the party to such initiatives as “defunding the police”.

Another key Republican issue which focuses the minds of their voting base is the ever-present discussion around immigration within the United States.



Figure 6: U.S. CPI breakdown



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of October 21, 2022.

Figure 7: Higher inflation driving misery index higher



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of October 21, 2022.

Among Republican campaigners, especially those with a strong alignment to former President Donald Trump’s wing of the party, the concerns around immigration have been consistently focused on. It remains clear that within the GOP, there appears to be a clear divide between candidates who wish to attack the Biden Administration on their handling of the economy whilst others are attempting to build momentum with voters around the Trump-driven agenda to “Make America Great Again”.

The influence of former President Trump remains strong within the Republican Party, with many coveting his endorsement during their respective campaigns. It was expected that in the build-up to the November elections, Trump would be able to rouse voters with his combative style and sense of authority over the party. It appears that this tactic has not been as effective as originally hoped; Trump’s own legal issues regarding the handling of classified documents from his time in the White House as well as continued investigations into his businesses, have cast a long shadow over many Republicans looking to gain votes by association.

For the Democratic Party, there is a sense of shifting momentum over the summer following a difficult period for President Biden and his Administration. The legislative success delivered in 2021, firstly taking control of the pandemic and delivering an infrastructure package, has been replaced by growing public frustration with the White House over the increasingly faltering economy and its inability to tackle rising inflation. President Biden himself has struggled to set the narrative as a President who can influence allies abroad to resolve issues at home. Biden’s much publicized visit to Saudi Arabia in July to stabilize energy markets (through increased oil supply) led to very little success at the cost of much political capital. Within 3 months after his visit, it was agreed by the Organization of Petroleum Exporting Countries (OPEC+) to further cut global oil production by 2m barrels per day in their attempt to keep oil prices elevated. Such a decision which will have far greater influence on the price of oil than the Biden Administration’s attempts to suppress energy prices by releasing its own strategic reserves into the market, which it has been doing since March. Currently, the U.S. Strategic Petroleum Reserve (SPR) is at its lowest level since 1984.

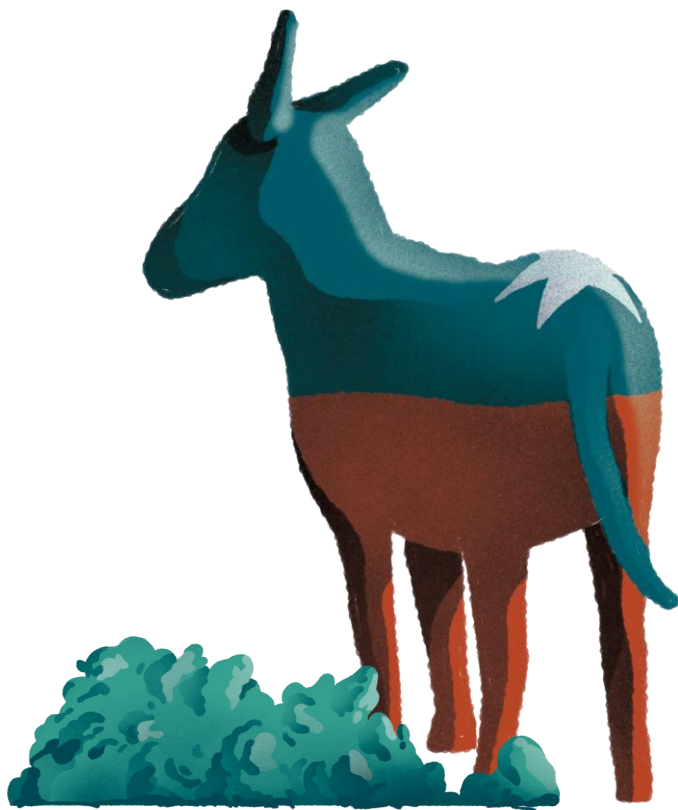
However, such setbacks for Biden and the Democrats appear to be receding, with a renewed focus on several social issues that have risen to the fore; mainly the decision by the Supreme Court to strike down the almost 50-year legal precedent that gave women the constitutional right to abortion in the United States, known simply as ‘Roe vs. Wade’. The decision to strike down the legislation from Federal law has caused a strong reaction across the country, which has increased the chances of a higher turnout on election day in favor of the Democratic Party. The politically charged nature of a woman’s right to an abortion will also certainly motivate supporters to step out from the sidelines, register and participate this November.



For those voters who reside in Republican states where there has been a more aggressive move to restrict any form of abortion following the Supreme Court ruling, it could well be seen as a key motivation to vote. Democratic campaigners have been quick to emphasize that a Republican victory at the midterms would increase the risk of more restrictive legislation not just on women's health but also broader democratic rights, such as civil liberties and climate change.

The change in fortunes for the Democrats in the polls, as well as in several special elections over the summer where Democratic candidates gained in a senate seat in Alaska as well as swing districts in the House of Representatives, was further cemented with the passing of a key piece of legislation for the Biden Administration. The Inflation Reduction Act (IRA) pushed forward by delivering on several policy pledges concerning climate change, healthcare as well as taxation. Regarding climate change, USD 369bn was pledged towards reducing the U.S. overall carbon emissions by 40% by 2030 alongside committing to various clean energy projects with USD 30bn allocated to such infrastructure as solar panels, wind turbines and geothermal plants. The passing of the IRA gave the Biden Administration the ability to evidence legislative progress with voters across the country, alongside the passing of the CHIPS and Science Act, which boosted domestic production of advanced semiconductors at time where supply-chain pressures (and U.S.-China tensions) are ever more acute.

Regardless of how the Democrats arrived at this juncture, there is certainly an increased feeling of optimism going into the midterm elections.



Further announcements recently around student loan forgiveness as well as mass pardons for individuals who were convicted for "simple possession" of marijuana show a party wanting to maintain momentum with younger, more liberal leaning voters. From the Republican perspective, such decisions taken by the Biden administration play into their narrative of a reckless government stoking the inflationary fires while ignoring the risk of rising crime. With only weeks left before votes are counted, political battlelines have been drawn for both Republicans and Democrats, a referendum on President Biden and his handling of the economy or a vote for freedom of choice. Very few states reflect these battlelines more than one located in the northeastern United States.

Pennsylvania has recently emerged as a key state to watch during the election as it has swung for both the Republicans in 2016 before moving back to its Democratic roots in 2020. The impending retirement of Senator Toomey from the U.S Senate ensures that the state represents a key battleground for both parties. Indeed, based on both the amount of money raised (USD87m) and spent (USD81m) by all candidates, Pennsylvania is comfortably at the top of the list for this election. Many of the issues dominating voters' concerns within Pennsylvania could easily reflect the national debate. Recent polling highlights that President Biden's unpopularity with voters remains a concern for the Democrats. For the Republicans, while it may well be an election boost to have the economy as the main concern for voters it is certainly an uncertain outcome when the second highest issue is abortion access; 5% higher than the national average.

The outcome of the Senate race in states such as Pennsylvania will give a crucial indication of what Congress will look like after November.

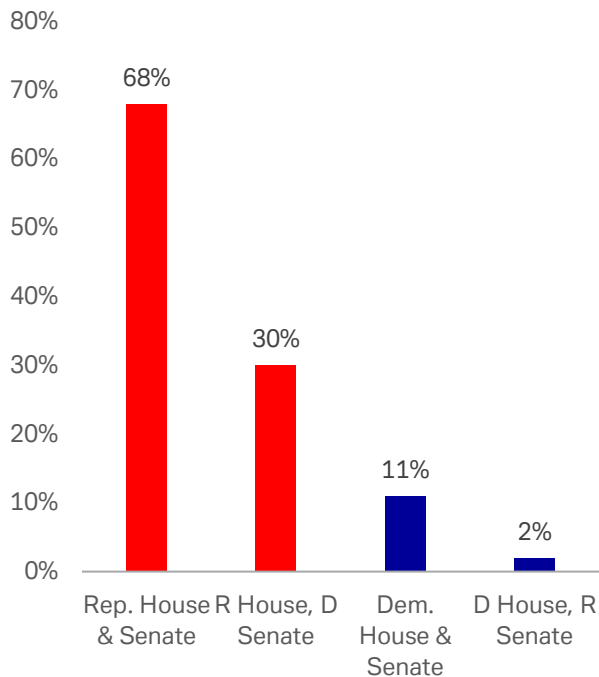
04 Possible Outcomes: Red Wave or Gridlock?

Using history as a guide, Republicans have a strong possibility of taking complete control of the U.S. Congress. Of course, it is important to note that the United States remains a closely divided country; with record electoral turnouts becoming the norm as seen in the 2020 Presidential election and 2018 midterms, it will no doubt be another tightly contested race. Betting markets have remained on the side of strong Republican gains with current odds suggesting a possible sweep in both the House of Representatives as well as the Senate.

In the instance that history continues its trend and the party in power comes out of the midterms weaker than when it entered, policy implications will be significant. Currently, our expectation is for that trend to remain. With an 80% probability, we forecast the Republicans to win either 1) both House and Senate or 2) win House or Senate. We forecast that there is only a 20% probability of the Democrats defending both House and Senate. Whilst there has been a tempering of expectations that November will witness a Republican 'Red Wave', there are strong signs that the historical pattern will indeed hold with the out-of-power party making gains, as was the case in 1994, 2010 and 2018.



Figure 8: Betting Odds: Midterm Election Outcomes



Source: Predictit.org, "What will be the balance of power in Congress after the 2022 election?", Deutsche Bank AG. Data as of October 21, 2022.

President Biden's low poll numbers will certainly be a factor, as has been the case in many other modern-day midterm elections. Combined with a faltering economy, the pathway to Republican success appears to be clear.

If such a scenario were to play out that the Republicans did in fact deliver a "Red Wave", the potential policy outcomes for the White House would alter dramatically. The progressive agenda that has been delivered so far by the Biden Administration would certainly come to a halt. Whilst it would be difficult to definitively list every policy that would be impacted by a Republican sweep, we can certainly expect headwinds to hamper the Biden Administration from delivering on either new spending or taxation plans. The focus on climate change and any subsequent renewable energy policies (beyond the recent passing of the Inflation Reduction Act) would be halted with a tilt towards ensuring the fossil fuel industry is given some protection. From a judicial perspective, a Republican-controlled House and Senate would be expected to be highly motivated to restrict the appointment of more Democratic leaning judges. Arguably one of the lasting legacies of the Trump presidency was the number of conservative appointments made over the Administration's four years, not just at the Supreme Court but also throughout all levels of the U.S. judicial system. The reaction from the Democratic Party to striking down 'Roe v. Wade' and their pledge to challenge many conservative decisions would certainly be nullified. Slowing down momentum in calls for greater regulatory oversight in certain industries, namely Technology, would also be expected.

Regarding foreign policy, there would be pressure from the Republican Party to become even more hawkish when dealing with China. The Biden Administration has remained cautious in its relationship with President Xi and the Chinese economy. Indeed, Democrats can certainly point towards the government's recent decisions around Chinese technology purchases as well as debates around Chinese companies who wish to list their stock on U.S. capital markets, as evidence of a strong administration on the global stage. Any increase in Republican seats, however, would result in even greater scrutiny of U.S.–China relations.

Given the politically divided nature (and record electoral turnouts) of the United States recently, it would be highly plausible for this division to be reflected in a gridlocked Congress. Based on current polling, it appears that the House of Representatives would move into Republican hands with the potential for the Democrats to remain in control of the U.S. Senate. Such a split could lead to a possibility of some progress in certain aspects of the legislative agenda, but only in certain areas. Defense spending will most likely increase under any scenario we are discussing given the renewed threats that are playing out in Europe with the Russia–Ukraine conflict, a geopolitical event where both Democrats and Republicans have voiced support for Ukraine. Where progress would be most keenly needed will be around the contentious issue of the debt ceiling. Currently, the U.S. has a debt limit set at USD31.4tn, which will need to be voted on to be increased and to avoid the risk of a debt default. The Republican Party, campaigning heavily against the Democrats fiscal record, will be highly focused on ensuring that any votes related to increasing the debt ceiling would be tied to reducing spending plans.

If the Democrats do hold onto their seats, then there would be a second chance to give Biden's agenda new life following a difficult two years. The Biden Administration would be able to push ahead with key parts of their legislative agenda, mainly centred around the Democrats 'Build Back Better' pledge, whilst also avoiding difficult negotiations with the Republican Party around such areas as the debt ceiling. Further focus around climate change and infrastructure initiatives, following on from the passing of the Inflation Reduction Act, are most likely. Within healthcare, the Democrats would be looking to extend subsidies for the cost of prescription drugs and Medicaid, ensuring that such legislation as the Affordable Care Act (otherwise known as "Obamacare") remains a key benefit. Any judiciary appointments made by the Democrats would be designed to retake control from what has been perceived to be a significant conservative shift over the last few years. Increased regulation around 'Big Tech' would be expected to remain on the agenda with a possible focus on cryptocurrencies and the impact of FinTech firms operating within this space. Overall, such a "Blue Wave" would have the largest market impact as it would increase the possibility of higher taxes as well as further government spending.



05 Midterms & Markets

The market impact of the midterms has generally been positive, underpinning the inherent strength of the U.S. economy. Looking into the various scenarios, however, while the upcoming elections could cause pain for the Democrats, markets would appear to take the combination of a split legislature and Democratic executive in its stride – delivering an annualized return of 16%.

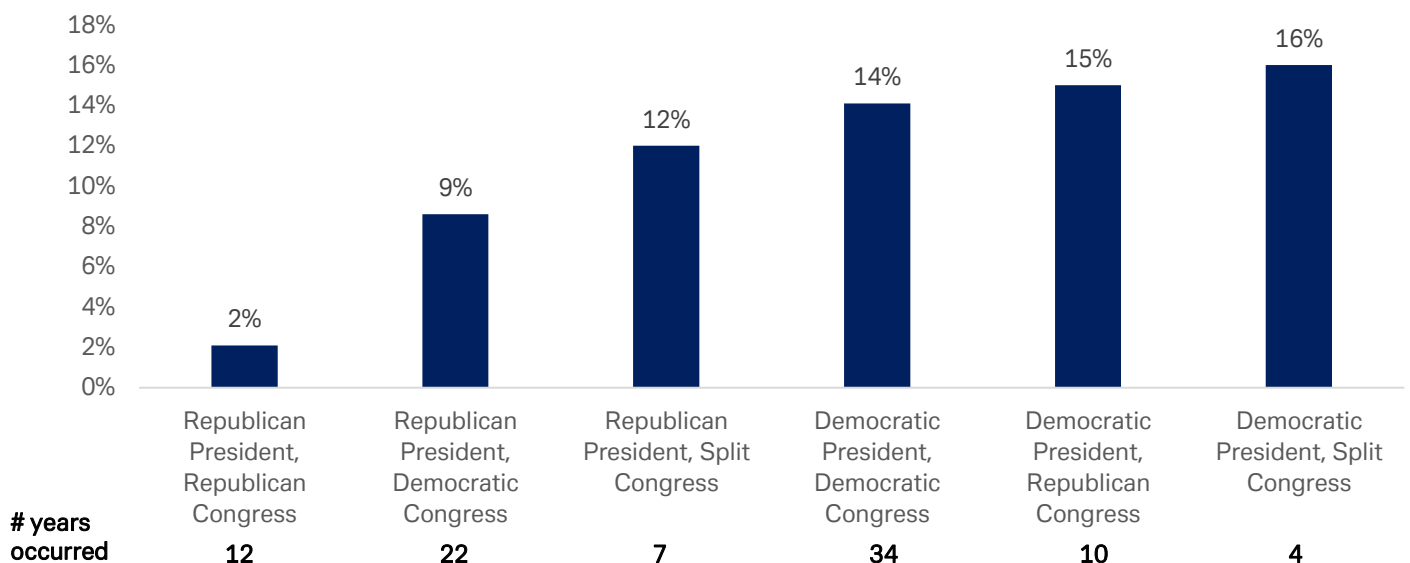
Such a positive trend in equity market returns exists for every possible election outcome between the U.S. Congress and the White House. The role of monetary policy over these periods also offers further insight into how markets could well respond as we enter 2023. Historically speaking, the positive returns found within the S&P 500 have been supported by a generally dovish Federal Reserve which gives equity markets an added boost. However, we are now dealing with an economic landscape that has not existed since the late 1970s when higher inflation was met with aggressive central bank rate tightening. With the Federal Reserve showing no signs of stopping their tightening cycle, markets will continue to experience bouts of heightened volatility. Global growth expectations have fallen and the probability of a 2023 recession in the U.S. has increased. Such factors will continue to influence markets as companies recalibrate their future earnings expectations.

Within Fixed Income, the key influences the midterm election will have over Treasuries will be the risk of failing to agree on the debt ceiling and a possible government shutdown. In either scenario that the Republican Party win both the House or Senate or just one of the respective chambers, there will be increased pressure on the Biden Administration to negotiate the debt ceiling with the opposition party. Given the previous

instances of brinkmanship and government shutdowns, Treasuries will most likely bear the brunt of any market volatility if this were to occur again.

From a sector perspective, there would certainly be winners and losers in the event of either a “Red Wave” or “Blue Wave” following the elections in November. As discussed above, the prospect of a clean sweep for the Biden Administration would reinvigorate their ‘Build Back Better’ pledge resulting in a more optimistic outlook for companies operating within either the Renewable Energy or Metals & Mining sectors given the increased demand for minerals such as Cobalt and Lithium. The continued push for further price control around drugs and medical services would act as a possible headwind for pharmaceutical companies and associated sectors. Increased regulation will have the greatest impact on the Technology sector, especially for companies where the contentious issue of data privacy is a major issue. The impact on these sectors would also certainly reverse in the instance of a Republican clean sweep with some relief found in sectors such as Tobacco or Consumer Staples where policies such as increased regulation or an increase in corporate tax would be taken immediately off the table. As is the case with betting markets currently, the sectors which appear to be performing well are mainly beneficiaries of a Republican victory at the polls, rather than a Democratic one.

Figure 9: Average annual S&P 500 total returns based on control of White House & Congress, 1928-present

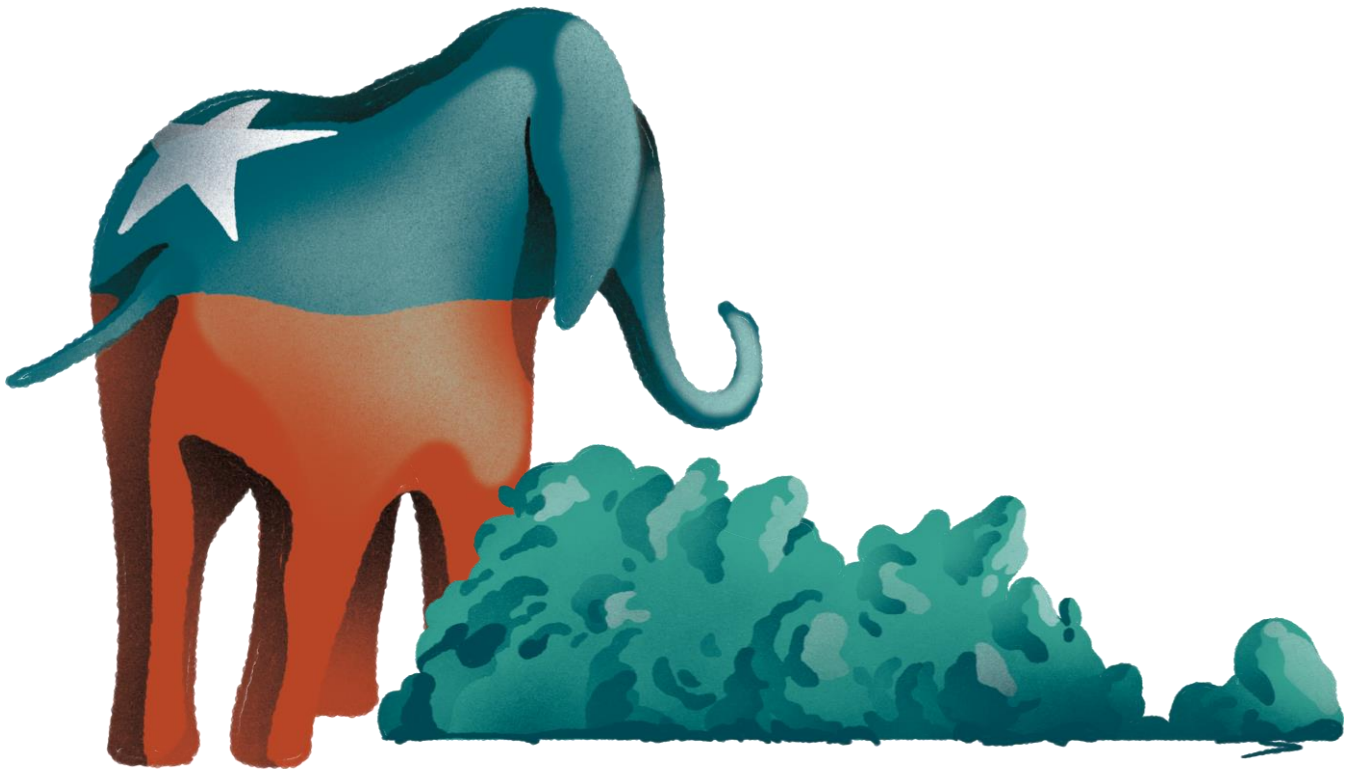


Please note data excluding 2008, average for Republican President, Democratic Congress is 10.2% (still the second-weakest period). Total returns 1936-present and price returns prior to that. Source: S&P, FactSet, BofA Merrill Lynch US Equity & Quant Strategy., Deutsche Bank AG. Data as of October 21, 2022.



06 Conclusion

In a year of significant economic slowdown, record-high inflation and geopolitical tensions in both Europe and Asia, it would be understandable for investors to have had enough to manage so far before considering the possible implications of the U.S. midterm elections. Yet even with the strong probability that the election outcome has already been predicted correctly, and the Republican Party will either take one or both chambers of Congress, it is important for investors to be mindful that such an outcome would have both policy and market implications. Regardless of the outcome on November 8, there will be challenges for the U.S. economy in the immediate future. The increased risk of recession and persistently high inflation will test the policy toolkit from both sides of the political spectrum. And before voters realise; it will be time to think about the next election.





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Glossary

The **consumer price index (CPI)** measures the price of a basket of products and services that is based on the typical consumption of a private household.

Congress is the bicameral federal legislature of the United States.

Democrats is short for the Democratic Party in the U.S., one of the two major parties.

The **Federal Reserve (Fed)** is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The **House of Representatives** is one house in the bicameral U.S. Congress with some exclusive powers e.g. to initiate revenue bills.

The **Organization of the Petroleum Exporting Countries (OPEC)** is an international organization with the mandate to "coordinate and unify the petroleum policies" of its 12 members. The so-called "**OPEC+**" brings in Russia and other producers.

Republicans is short for the Republican Party, one of the two major parties in the U.S.

The **Senate** is the smaller house in the bicameral U.S. Congress, with a more deliberative function.

The **S&P 500** Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.



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