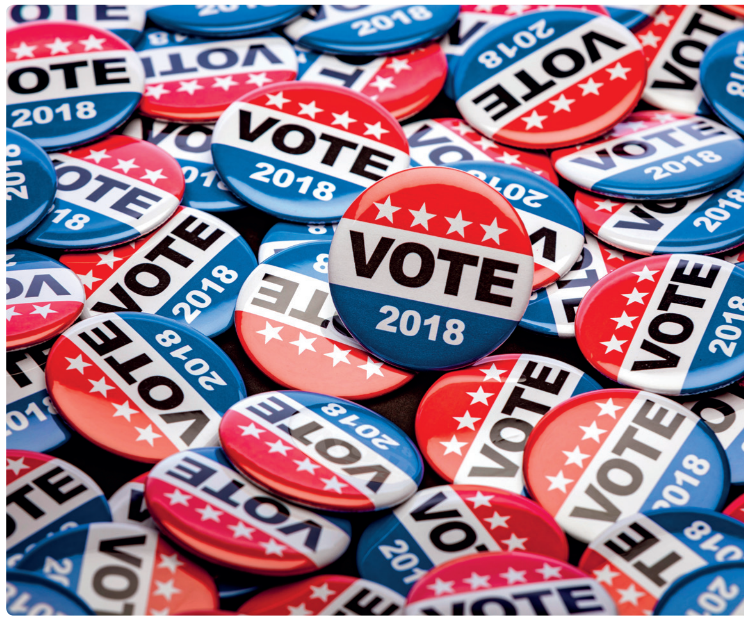
US midterms: three scenarios for investors



The American midterm elections are approaching and the crystal ball gazing has begun. Here's what investors should consider regardless of whether the US votes for a 'distilled Donald', the 'Democratic double' or a 'divided democracy'.

Ben Bennett is the Head of Investment Strategy and Research, coordinating LGIM's research from long-term themes to short term market drivers.

Lars Kreckel has overall responsibility for LGIM's global equity strategy with a focus on LGIM's global equity strategy views within LGIM's Asset Allocation team.

As was the case with the 2016 Brexit vote, the 2016 US Presidential election and the 2017 UK general election, predicting the outcome of the upcoming US midterms has become something of a pastime for investment and political commentators. Yet as these examples so clearly demonstrate, political events are, by their very nature, political, and therefore very difficult to predict. We believe there's more value in preparing for a range of eventualities.

Let's consider the three possible scenarios for the outcome of the vote (to each of which we assign subjective probability) and how both the policy and investment narrative could shift under each one.

Scenario 1: Donald distilled – Republicans retain both chambers (low chance)

President Trump's Republican Party currently holds sway in both US Chambers of Congress: the Senate and the House of Representatives. However, the status quo is not expected by markets to prevail. As such, the investment narrative could shift markedly if it does.

With Trump's power consolidated, we could expect a narrative of a more 'distilled Donald', with increased focus on 'America first' policies. The **huge fiscal stimulus** from this year's tax cuts could be made a more permanent feature or even expanded, talk of impeaching the president would likely become yesterday's news, while trade tensions between the **US and China** could ratchet up several notches.

The investment environment could change accordingly. Think in terms of pressure for an even stronger dollar and higher Treasury yields. On a relative basis, this would favour continued outperformance from domestic US markets (e.g. the S&P 500 and US high yield) and further pressure on emerging market assets.

Legal & General
INVESTMENT MANAGEMENT

In absolute terms, moves in risky assets would likely depend on the size of the shifts in the US dollar and Treasury yields. The bigger the moves, the worse it will be.

Scenario 2: Democratic double – Democrats win both chambers (low chance)

Equally significant for the political narrative would be a 'Democrat double'. A rejuvenated Democratic party could result in impeachment hearings (although **we believe an actual impeachment of Trump is unlikely**) and government inertia, including limitations to changes in healthcare policy. The odds of a Democratic president in 2020 would depend on the margin of the Democratic sweep.

Like the 'Donald distilled' scenario, the 'Democratic double' is not the market's base case, and a U-turn in market narrative could be the result. Overall, we believe the 'Democratic double' could lead risk assets to fall.

Think in terms of the potential for a weaker dollar, lower bond yields (as fiscal spending is reigned in), underperformance in domestic US assets and easing pressure on emerging markets. This scenario could also provide a headwind for large pharmaceutical companies, given healthcare changes, as well as for banks if stricter regulation becomes a theme.

Scenario 3: Divided democracy – Split chambers (high chance)

If the Democrats take the House, we believe the likely political narrative can be summed up as 'more of the same'. In this 'divided democracy', impeachment remains unlikely, and President Trump could still win a second term in 2020. Anti-trade policies would be likely to continue, with the possibility of a bi-partisan infrastructure deal.

We also believe that the market reaction would be contained as this scenario may already be priced in: expect a modest reaction in terms of US rates and the dollar, with the likely lack of volatility proving broadly positive for risky assets.