

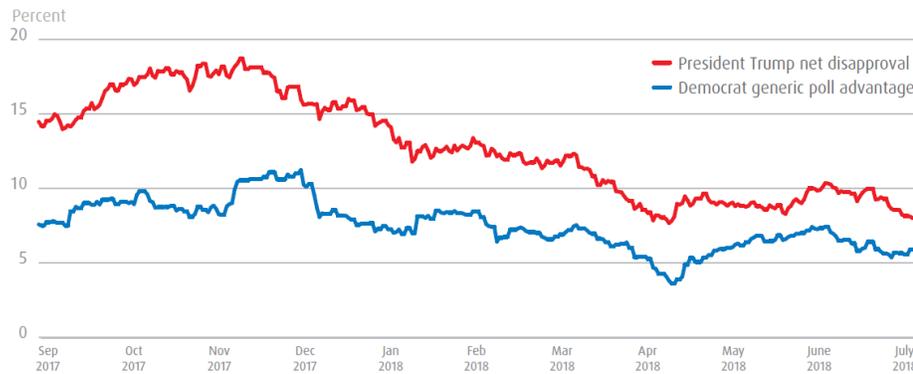
Market and Economic Insights  
**Strategy Spotlight**



**U.S. midterms: will a blue wave rock the boat?**

U.S. midterm elections typically serve as a referendum on the first two years of a president’s term, often resulting in steep congressional losses for the president’s party. The 2018 election appears to be following a similar pattern, with the Democrats’ lead on a generic congressional ballot peaking in late 2017 when President Trump’s net disapproval rating was also at its highest. However, as the economy has maintained momentum through 2018, President Trump has gained popularity while the Democrats’ prospects have declined modestly.

**Congressional voter intentions track presidential polls**



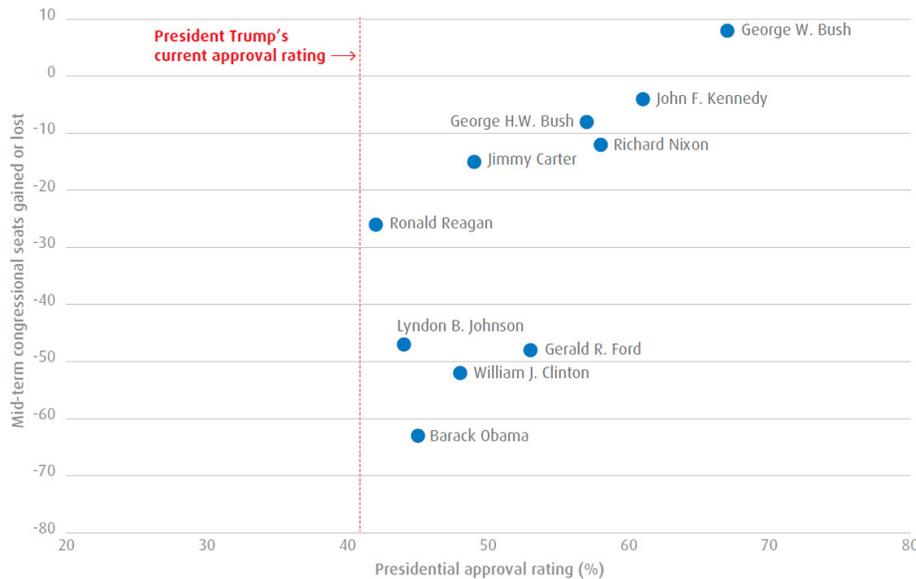
Sources: RealClearPolitics, BMO Global Asset Management

The U.S. House of Representatives tends to have significant turnover in party composition due to the short two-year terms for each member. Republicans currently hold a 23-person majority in the House but will need a strong showing in November to protect that majority. Inputting President Trump’s relatively low 41% average approval rating into a simple regression analysis of first-term presidents’ midterm election results (starting with John F. Kennedy) indicates Republicans are expected to lose 45 seats in the House. Considering they need to hold 23 seats, this analysis suggests the Democrats should be favored to take the House. Further, we think the Democrats’ chances are increased due to the actual results they have posted in special elections over the trailing year, particularly in Republican - leaning districts in Pennsylvania, Kansas and Ohio. They have momentum and enthusiasm on their side, which should bring out their voters.

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First-term presidential midterm election outcomes



Sources: UCSB The American Presidency Project, RealClearPolitics, BMO Global Asset Management



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Republicans hold a stronger advantage in the Senate, where six-year terms mean fewer seats in play during a given election year. The current composition is 51 Republicans and 49 Democrats (including Independents who caucus with Democrats). However, the 2018 election map favors the GOP, with 26 Democratic seats up for reelection compared to only nine for Republicans. Thus, the odds of Democrats taking the Senate — while certainly realistic — are lower than their House chances.

Election outcomes and expected implications

Outcome	Assessed likelihood	Expected market implications
Split government	High	Mostly priced in. Democrats will ramp up investigations into President Trump’s actions and strive to thwart his agenda wherever possible. Likely a stalemate for two years as both parties posture into the 2020 elections.
Republican hold	Moderate	Short-term positive. Potential for further tax reform and continued deregulation. Raises probability of Democrats moving further left in 2020, which would be negative for the U.S. market over the longer term.
Democrat sweep	Moderate	Short-term negative for the U.S. market and positive for international markets. Democrats will likely push for impeachment, but the necessary two-thirds supermajority in the Senate would make this a high hurdle. Democrats would attempt to blunt some of Trump’s hardline trade policies, particularly with current allies (and likely excluding China). Dollar negative as deficit spending likely to increase further.

We do have some concerns regarding a split government, as equity returns tend to underperform during these periods. One theory is that a split government slows down the response to bubbles and crises, as was clear during 2007–2008. However, the U.S. economy is on firm footing over the medium term, so we are less concerned with the composition of the government. Our concern would increase if the economy decelerates, as a sluggish government response would provide more downside.

	S&P 500® annualized real return (%)	Percentage of instances (%)
Democratic control	7.6	27.7
Republican control	12.6	9.8
Split government	4.6	62.5

Sources: BMO Global Asset Management, House.gov, Senate.gov, Library of Congress  
 Note: Analysis starts in January 1961.



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### Conclusion

The midterm elections have the potential to shape U.S. policy over the coming years and thus we are watching them closely. However, we do not see the outcome of these elections disrupting the U.S. economy’s strong growth over the medium term and we remain comfortable with an overweight to U.S. equities in our portfolios.

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