

ElectionWatch

18 October 2022
Chief Investment Office GWM
Investment Research

Top 10 questions on the 2022 US midterm elections



The final countdown

ElectionWatch
virtual event

26 October 2022

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State of the race

The US constitution delegates responsibility for election administration to state governments. In the early days of the republic, white men who owned property were entitled to cast public votes by voice at the local courthouse. Paper ballots became more popular by the middle of the 19th century after newspapers began to publish lists of candidates for public office, which could then be used by prospective voters. Political parties subsequently adopted the practice of distributing their own pre-printed and completed ballots, which resembled railway tickets, to the party faithful. These could be deposited directly into the ballot box—hence the phrase “voting the straight party ticket.”¹

A lot has changed since those early days. Mechanical voting machines were in use for decades. Punch cards supplanted metal levers until optical scanning machines became popular. Today, many states have adopted absentee ballots and early voting as an alternative for registered voters. According to the US Election Project at the University of Florida, more than 100,000 votes had been cast in various states by the first week of October. As a nation, we are *already* voting in the midterm elections.

The incumbent president’s party generally suffers from a loss of enthusiasm in the midterms. That certainly appeared to be the case earlier this summer when Republicans were well positioned to capture both houses of Congress. A Supreme Court opinion and a handful of legislative accomplishments have boosted Democratic prospects, but it may not be enough to avoid the loss of one chamber of Congress, and perhaps the second, to the GOP. Voter turnout, in person or by mail, will determine the outcome.



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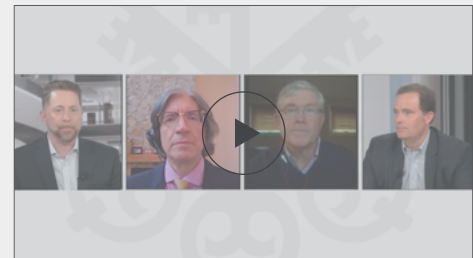


Nadia Lovell
Senior Equity
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ElectionWatch summary

Video

Midterms impact and sector outlook



Hear Eric Potoker, US Healthcare Equity Strategist; Brad Ball, US Financials Equity Strategist; and Jay Dobson, US Energy & Utilities Equity Strategist discuss our latest report.

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Top 10 questions on the election



1. What are the key policy issues for voters in this election cycle?

In a survey conducted by the Pew Research Center in August, more than 75% of the respondents identified the economy as the preeminent policy issue in their decision to support a particular candidate.



2. Is geopolitical risk a major factor in this election?

US support for Ukraine in its war with Russia remains popular among the public, as does the adoption of a more adversarial posture toward China. In this midterm election, we believe voters are more likely to view geopolitics through the prism of the US economy instead.



3. What about the federal deficit?

The Fed's belated but aggressive response to persistent inflation has begun to alter the narrative. Rising yields make the cost of servicing the federal debt more expensive.



4. Are public opinion polls a meaningful indicator of election outcomes?

Pollsters face recurring challenges in an era where fewer individuals respond to unknown callers. It is also important to remember that poll results are accompanied by a margin of error and therefore should never be treated as highly precise predictions.



5. Will the midterms affect the Federal Reserve's approach to monetary policy?

The Fed is currently engaged in a restrictive monetary policy, providing evidence that it will pursue its twin mandates of price stability and maximum employment deliberately despite the potential for political consequences.



6. What changes can we expect in terms of the composition of Congress?

The GOP is expected to capture the House of Representatives, but control of the Senate remains highly competitive.



7. Will the midterm election results affect market performance?

We expect equity and fixed income markets to remain volatile and be driven by the Fed's actions, inflation, and economic growth rather than a shifting political landscape.



8. Will control of Congress have a material impact on legislation?

In a divided Congress, which is our base case, domestic legislation will require a degree of compromise.



9. What issues might arise in 2023 that could have a more palpable market impact?

One risk is a failure to raise the debt ceiling. As concern over the deficit grows, recalcitrant members of Congress may demand political concessions in return for a vote to raise the debt ceiling.



10. Should I adopt a new investment strategy in response to the midterm elections?

We do recommend a defensive investment strategy, but we do so because the Fed's exceptionally tight monetary policy has contributed to greater economic uncertainty.

See the following pages for more detailed answers ✓

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1. What are the key policy issues for voters in this election cycle?

The state of the economy takes center stage in voters' minds as they head to the polls every November. This year is no exception. In a survey conducted by the Pew Research Center in August, more than 75% of the respondents identified the economy as the preeminent policy issue in their decision to support a particular candidate. Nine out of 10 registered Republicans and voters who "leaned Republican" rated the issue as most important. Two-thirds of registered Democrats and Democrat-leaning voters agreed, which goes to show how pocketbook issues continue to resonate with voters regardless of party affiliation.¹

Crime and public safety have also risen in importance among prospective voters. In a recent Politico/Morning Consult poll, more than 75% of respondents cited violent crime as a major problem.² Not surprisingly, GOP candidates are focusing on inflation and public safety, along with immigration, in their campaigns for Congress.

The Supreme Court decision in *Dobbs v Jackson Women's Health Organization*, which eliminated the constitutional right to an abortion, altered the electoral landscape by rousing an apathetic Democratic base weighed down by the performance of an unpopular president. The Pew Research survey, conducted in the wake of the high court decision, showed that registered Democrats remain focused on healthcare and abortion rights—some even more so than on the economy—as touchstone issues. Participation in primary elections increased after the SCOTUS decision, with Democratic candidates outperforming expectations.

Voter turnout in midterm elections is generally higher for the party in opposition to the incumbent president, so the outcome this year may depend upon whether Democrats can motivate their base to participate in this election in greater numbers than history would suggest.

2. Is geopolitical risk a major factor in this election?

Foreign policy considerations and geopolitical risks can influence voter behavior, but the impact is more pronounced in presidential elections than in the midterms. The 2004 presidential election, pitting incumbent president George W. Bush against senator John Kerry, is a good example. In that election, Bush and Kerry frequently sparred over

questions of national security in the wake of the 9/11 attacks.

US support for Ukraine in its war with Russia remains popular among the public, as does the adoption of a more adversarial posture toward China.³ In this midterm election, we believe voters are more likely to view geopolitics through the prism of the US economy instead. Inflation remains high and is proving to be more persistent than initially anticipated by the Federal Reserve. The decision by the OPEC and allied oil producers (OPEC+) to reduce production has already triggered a rebound in fuel prices, which may undermine President Joe Biden's ability to convince voters that inflation is subsiding.

3. What about the federal deficit?

The size and scope of the federal deficit has been a recurring political issue for decades, but its rhetorical potency had diminished until very recently. Extremely low interest rates had prevailed for more than a decade, which made financing the budget deficit inexpensive. However, Congress added another USD 3.4 trillion of borrowing for pandemic relief, pushing the accumulated deficit to unprecedented levels.

The Fed's belated but aggressive response to persistent inflation has also begun to alter the narrative. Rising yields make the cost of servicing the federal debt more expensive. The gross national debt of the US now exceeds USD 31 trillion only nine months after surpassing USD 30 trillion in January.⁴ In May, the Congressional Budget Office projected that interest payments will exceed USD 8 trillion over the next decade absent corrective budgetary action. If interest rates are 1% higher than the CBO projected earlier this year—and they are—interest on the national debt will rise by another USD 2.4 trillion through 2032.⁵

Congress has pursued a variety of initiatives to restrain the growth in spending. By and large, these have been unsuccessful because the political will to raise tax revenue or reduce spending has been absent. Bipartisan compromise is necessary for any successful effort at deficit reduction, and prospects for that type of agreement in the near term are limited. The status of the US dollar as the global reserve currency has insulated the US from the need to exercise strict fiscal discipline, but larger deficits will still place a greater financial burden on future generations and narrow the options available when the next crisis occurs.

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4. Are public opinion polls a meaningful indicator of election outcomes?

Skepticism over the accuracy of public opinion polls has increased. According to the American Association of Public Opinion Research (AAPOR), polls conducted in advance of the 2020 presidential election were the least accurate in 40 years for the national popular vote.⁶ The polling error was too favorable for Biden by 3.9 percentage points in national polls and by 4.3 percentage points in statewide polls. The AAPOR study rejected a host of explanations for the discrepancy, ranging from the shy Donald Trump voter who might be reluctant to respond candidly to a pollster, to ambivalent voters choosing a GOP candidate in the final days of the campaign.⁷

Instead, sampling error may be to blame. There may have been too many Democratic respondents, for example. It is also possible that individuals who did choose to identify themselves as registered Republicans were the ones more likely to support a Democratic candidate. Pollsters face recurring challenges in an era where fewer individuals respond to unknown callers. It is also important to remember that poll results are accompanied by a margin of error and therefore should never be treated as highly precise predictions. The last presidential election was decided by fewer than 50,000 votes in three states, so the margin of error will always be a factor.

5. Will the midterms affect the Federal Reserve's approach to monetary policy?

No. The Fed has exhibited a consistent willingness to adjust short-term interest rates either to restrain the rate of inflation or to stimulate economic growth without regard to impending elections.⁸ While Fed chairs are occasionally subjected to withering criticism over monetary policy, as was the case under presidents Lyndon B. Johnson, Ronald Reagan, and Trump, the US central bank has managed to navigate the rocky shoals of partisan politics for decades.

The Fed is currently engaged in a restrictive monetary policy, providing further evidence that it will pursue its twin mandates of price stability and maximum employment deliberately despite the potential for political consequences. For the time be-

ing, Chair Jerome Powell has made it clear that price stability is the paramount consideration. We expect the Fed to raise the policy rate again on 2 November, less than a week before Election Day.

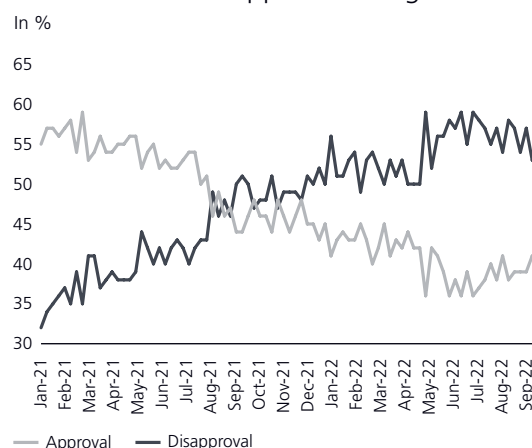
6. What changes can we expect in terms of the composition of Congress?

Midterm elections are notoriously challenging for the party in control of the White House. The incumbent president's popularity is a critical factor in midterm election campaigns. President Biden's job approval rating has improved marginally in recent months but is still mired at levels that should present a drag on the reelection campaigns of House Democrats in competitive districts.

Democrats were disheartened six months ago when polls suggested that they would lose dozens of seats in the House and surrender control of the Senate. The Supreme Court decision in *Dobbs* boosted their confidence by providing a platform to counter Republican criticism that the Biden administration has been an ineffective manager of the national economy. As we approach the final weeks of the campaign, our colleagues in the UBS US Office of Public Policy have refined their election outcome probabilities. The GOP is expected to capture the House of Representatives, but control of the Senate remains highly competitive.

Figure 1

President Biden's approval ratings



Source: Reuters, UBS, as of 4 October 2022

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	Republican sweep	Divided Congress	Status quo
Scenarios	Republicans assume control of both the Senate and the House	Democrats retain control of the Senate but lose the House	Democrats retain narrow control of both chambers of Congress
Probabilities from UBS US Office of Public Policy	30%	60%	10%

7. Will the midterm election results affect market performance?

Midterm elections have had little immediate impact on market performance in the past, and we expect that pattern of behavior to continue. As we discussed in a prior edition of *ElectionWatch*, bond yields have exhibited only modest movements around the dates of prior elections. The midterm elections should not be the immediate cause of any fixed income market volatility.

We also do not expect midterm election results to affect the broader stock market. Historically, the market tends to trade sideways in the months preceding Election Day and then rallies in subsequent months. However, that historical pattern has already been challenged this year, as tighter monetary policy has been a major headwind to the market and is likely to persist. We expect equity and fixed income markets to remain volatile and be driven by the Fed's actions, inflation, and economic growth rather than a shifting political landscape.

8. Will control of Congress have a material impact on legislation?

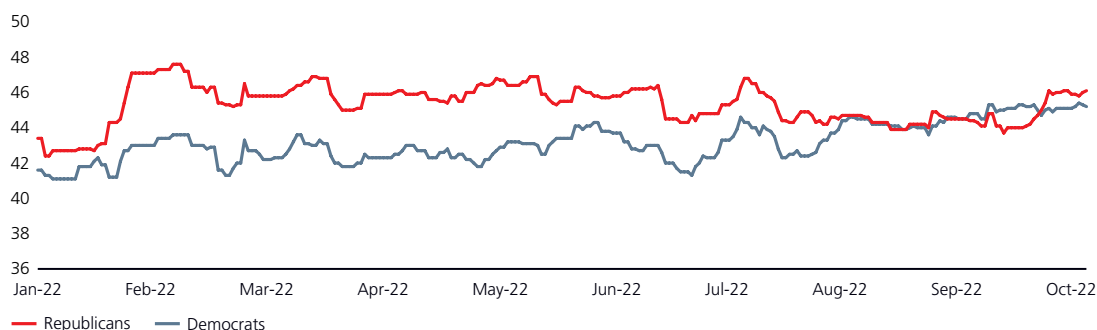
In a divided Congress, which is our base case, domestic legislation will require a degree of compromise. We expect a Republican House to exercise more rigorous oversight of executive agencies and to advocate for a more lenient regulatory regime, but the GOP's ability to advance formal legislation will be constrained. We believe foreign policy and geopolitics will preoccupy the latter half of President Biden's term of office.

We expect that the Senate will remain in the hands of Democrats, but the margin of control should remain exceptionally narrow. Even in the event the GOP does recapture control of the Senate, enactment of most legislation will require some votes from each side of the aisle and the signature of the president. Along those lines, we do expect Congress to enact a major agriculture bill in 2023, which ultimately will receive the support of both parties after lengthy negotiations.

Figure 2

2022 generic congressional vote average

% of voters who say they intend to vote for either party's candidate for the US House of Representatives in their district



Source: Real Clear Politics, UBS, as of 7 October 2022

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9. What issues might arise in 2023 that could have a more palpable market impact?

Congress has an unenviable record in terms of enacting budgets on a timely basis. According to the National Conference of State Legislatures, Congress relied on continuing resolutions (CRs) 43 times between 1977 and 2019.⁹ They did so again three weeks ago. CRs typically extend existing funding from a previous fiscal year for a defined period while budget negotiations are underway. On occasion, the absence of a budget or a CR has triggered a partial government shutdown. The probability of this happening in 2023 is rising, but investors have become a bit desensitized to shutdowns, so the market impact should be limited.

The bigger risk is a failure to raise the debt ceiling. As concern over the deficit grows, recalcitrant members of Congress may demand political concessions in return for a vote to raise the debt ceiling. We expect that Congress will have to act again by the third quarter of 2023.¹⁰ Any failure to raise the debt ceiling constitutes a default, even if the Treasury chooses to prioritize the payment of government debt over other expenditures. Rating downgrades and an abrupt increase in market volatility would necessarily follow. Congress conceivably could raise the ceiling in the lame-duck session of Congress, but the vote is more likely to occur next year. The potential for partisan brinksmanship and a political stalemate in 2023 is worth monitoring.

10. Should I adopt a new investment strategy in response to the midterm elections?

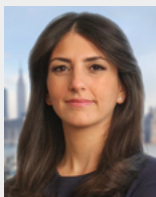
We do recommend a defensive investment strategy, but we do so because the Fed's exceptionally tight monetary policy has contributed to greater economic uncertainty. We expect inflation to remain higher than normal over the next several quarters, which is likely to reinforce the Fed's commitment to higher interest rates. The risk of recession is rising, so the construction of a resilient portfolio is more important than ever.

Value stocks tend to outperform growth stocks when inflation exceeds 3%, so a focus on positive cash flow and profitability is appropriate. We expect consumer staples and healthcare stocks to outperform other equity sectors. Energy is not inherently defensive, but the war in Ukraine has interrupted commodity flows, raised prices, and made the sector more attractive.

Within fixed income, a cross-asset barbell is appropriate for private clients in the US. An inverted yield curve has made the front end of the Treasury curve very attractive. On the longer end, the yield on high grade tax-exempt municipal bonds can exceed the yield on corresponding US government securities. The probability of default is low, and there is minimal correlation with equities. Finally, we recommend an allocation to hedge funds, particularly discretionary macro strategies, and private markets for their diversification benefits and historical lack of correlation to other asset classes.

ElectionWatch virtual event

Event



Solita Marcelli
Chief Investment
Officer Americas



Jeb Hensarling
Vice Chairman for
UBS Americas



Jason Chandler
Head of Wealth
Management USA

Our second *ElectionWatch* event will focus on domestic policy, the economy and potential election outcomes. Please join us for a conversation with Solita Marcelli, Chief Investment Officer and Jeb Hensarling, Vice Chairman for UBS Americas hosted by Jason Chandler, Head of Wealth Management USA.

Wednesday, 26 October 2022
1:00–1:30 PM ET

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Endnotes to “State of the race”

¹ Dave Roos, “How Americans Have Voted Through History: From Voices to Screens,” History.com, 13 April 2020, updated 2 November 2020.

Endnotes to “Top 10 questions on the election”

¹ Pew Research Center, “Abortion Rises in Importance as a Voting Issue, Driven by Democrats,” 23 August 2022.

² Elena Schneider, Politico, 5 October 2022.

³ Patricia Zengerie, “Three in four Americans say U.S. should support Ukraine despite Russian threats, Reuters/Ipsos poll shows,” Reuters, 5 October 2022. See also Laura Silver, “Some Americans’ views of China turned more negative after 2020, but others became more positive,” Pew Research, 28 September 2022.

⁴ See press release, Committee for a Responsible Federal Budget, 3 October 2022.

⁵ Committee for a Responsible Federal Budget, “What Would Higher Interest Rates Mean for the Debt?” 14 June 2022. Congressional Budget Office, “The Budget and Economic Outlook: 2022-2032,” 25 May 2022. The CRFB estimates that interest payments will total USD 10.7 trillion alone over the next decade and budget deficits will increase by an average of USD 285 billion per year if interest rates are 1% higher than the CBO forecast.

⁶ American Association of Public Opinion Research, “Task Force on 2020 Pre-Election Polling: An Evaluation of the 2020 General Election Polls 2021.” Polls were also inaccurate at state-level polling, but the data is only available for the past 20 years.

⁷ Ambivalent voters breaking for Donald Trump were a source of polling error in 2016, but the AAPOR concluded that was not the source of polling error in 2020.

⁸ “Do Policy proposals matter?” *ElectionWatch*, UBS, 15 January 2020.

⁹ Brian Wanko, “Budget season arrives and chaos reigns,” National Conference of State Legislatures, 7 September 2022.

¹⁰ For a detailed explanation of the debt ceiling, please refer to the CIO blog “The return of the debt ceiling debate,” published 16 August 2021.

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