

ElectionWatch

8 September 2022
Chief Investment Office GWM
Investment Research

A consequential summer ahead of the **2022 US midterm elections**



Shifting fortunes

ElectionWatch
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21 September 2022

[Click here to
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2 State of the race

3 A consequential summer

6 How to invest

7 Scenario analysis

10 Voters react to Supreme Court decisions

11 Midterms timeline

12 Appendix

State of the race

A week is a long time in politics.

Harold Wilson, 1916–1995

Having served as British prime minister on two separate occasions, Harold Wilson had a career that is testament to the notion that political fortunes can change rapidly in highly contested election campaigns. Wilson's adage is worth remembering, even as the probability of a Republican sweep in the US midterms has diminished in recent weeks. With another eight weeks before the elections, the odds of one party or the other gaining seats in Congress is likely to shift again.

Voter turnout tends to decline in midterm elections, which usually benefits the party in opposition to the White House—critics of incumbent presidents are more motivated to register their dissatisfaction at the ballot box. However, there is some evidence to suggest that the usual historical pattern may not prevail in this cycle.

For example, actual voter turnout in the Kansas primary election exceeded 47%, despite earlier predictions by the secretary of state that only 36% of registered voters would participate. The unusually high number of independent voters who decided to participate in the primary election followed the Supreme Court's decision to rescind federal constitutional protection for abortion six weeks earlier. Results from recent special elections in Nebraska, Minnesota, and New York also suggest a narrowing of the enthusiasm gap.

The volatility that has confounded markets this year appears to have extended into the political arena.



Solita Marcelli
Chief Investment
Officer Americas



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Head of Fixed
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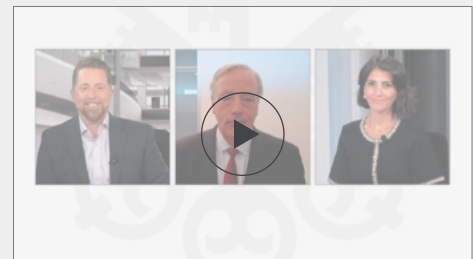


Nadia Lovell
Senior Equity
Strategist Americas

ElectionWatch summary

Video

Midterms impact and outlook



Hear Solita Marcelli, Chief Investment Officer Americas and Tom McLoughlin, Head of Fixed Income Americas, discuss our latest report.

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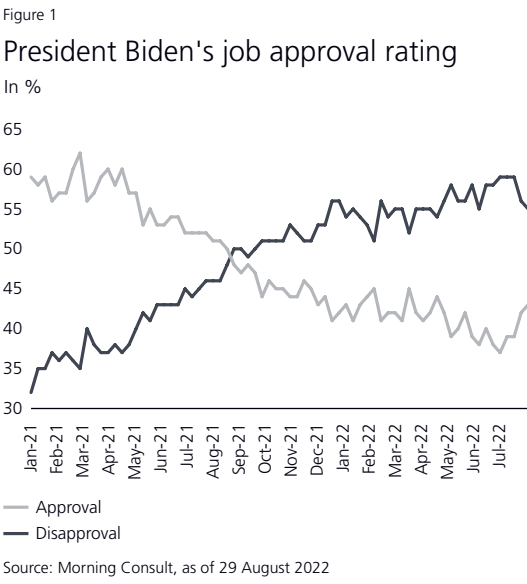
- 2 State of the race
- 3 A consequential summer
- 6 How to invest
- 7 Scenario analysis
- 10 Voters react to Supreme Court decisions
- 11 Midterms timeline
- 12 Appendix

A consequential summer

History suggests that the president’s political party should expect to lose some congressional seats in the midterm elections, which are viewed as a referendum on the performance of the chief executive. The popularity of the person holding the nation’s highest office tends to diminish after two years due in part to incessant media coverage which tends to amplify periodic gaffes. When the president’s job approval rating declines more precipitously than usual due to political blunders or policy mistakes, the party in power pays a heavier price at the polls.

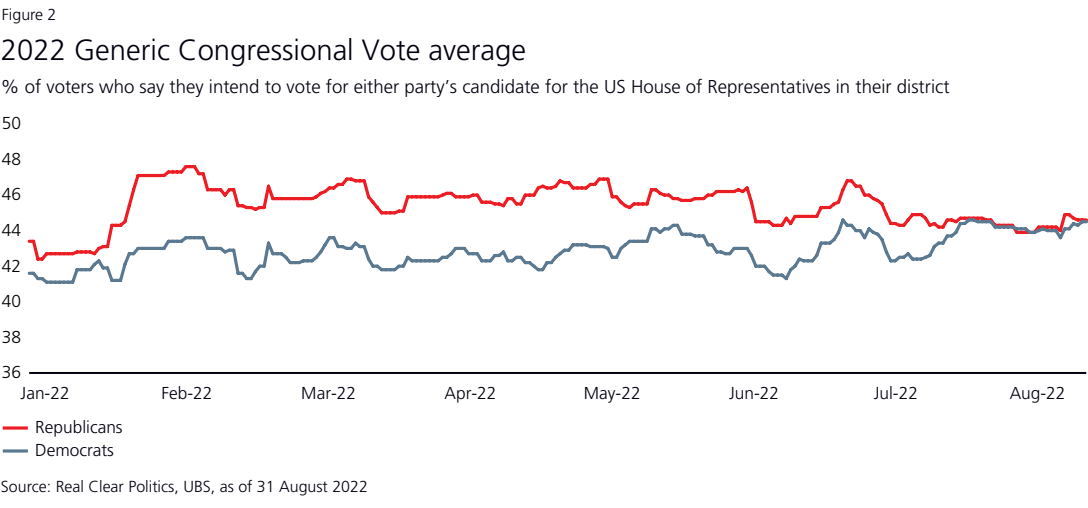
The nexus is strongest in the House of Representatives, where the party affiliated with the Oval Office almost always loses seats.¹ For recent examples, we need only reference the “shellacking” that House Democrats took in 2010 or the defeats suffered by their Republican counterparts eight years later.² Senators enjoy a higher profile than members of the House of Representatives and tend to be more insulated from a decline in the personal appeal of the sitting president. The six-year term accorded senators under the constitution also plays a role, because the upper chamber’s most vulnerable members may not need to seek reelection in the middle of a presidential term.

We have discussed this dynamic in prior editions of ElectionWatch but reiterate it here because this year’s midterms—surprisingly—are shaping up to be more competitive than originally anticipated. Six months ago, as state primary elections were just



getting underway, Republicans were expected to handily win a large majority of seats in the House and recapture control of the Senate. President Joe Biden’s personal popularity had not recovered from the chaotic US withdrawal from Afghanistan, and congressional Democrats were fighting among themselves over major tax legislation.

If a week is a long time in politics, then six months can seem like a lifetime. President Biden’s net job approval rating remains mired in negative territory (Fig. 1), but Democrats are now favored to retain narrow control of the Senate. The GOP is still expected to



2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

flip enough seats in the House to regain a majority, but the expected margin is smaller than originally forecasted. The disparity between Biden's low job approval rating and the optimism now voiced by Democrats is a striking summer development.

The heightened competitiveness is due to a variety of factors ranging from the nomination of inexperienced GOP candidates to a Supreme Court decision that has motivated Democrats and unaffiliated voters to turn out in greater numbers. Legislative successes in the form of the CHIPS and Science Act and the Inflation Reduction Act also may have played a role. The former, which enjoyed bipartisan support, provides USD 52 billion worth of subsidies and tax credits to encourage domestic production of semiconductors and another USD 170 billion for scientific research. The latter is wide-ranging and transformative, as discussed in detail below.

Inflation Reduction Act alters the outlook

After months of dissension within the Democratic caucus, the budget reconciliation bill was passed

on a party-line vote. The running joke in Washington had the Build Back Better bill retitled as either Build Back Later or Build Back Never, which may explain why the moniker was abandoned in favor of the Inflation Reduction Act (IRA). The new title is a bit of a misnomer—there is little to suggest that its provisions will put a serious dent in the rate of inflation—but it does represent a watershed event in terms of federal healthcare, energy, and climate policy.

The US healthcare system is notoriously complex, relying as it does on a combination of public and private insurance to provide individual medical coverage. According to the Association of American Medical Colleges, nearly 1 in 5 Americans now carry medical debt on their household balance sheets. Total aggregate spending on healthcare has hovered near 20% of US GDP in recent years. And while hospital care as a percentage of total healthcare spending has remained relatively flat, pharmaceutical expenditures more than doubled between 1980 and 2006.³

UBS Investor Sentiment survey

External view

As we discussed in a prior edition of ElectionWatch, political affiliation often has a direct impact on one's degree of optimism regarding the future direction of the economy.¹ Market participants who share an affiliation with the political party in office are more likely to accept greater risk and thereby earn correspondingly higher returns. Conversely, those disappointed with an election outcome often adopt a risk-off strategy to their detriment.

Our most recent UBS Investor Sentiment survey asked respondents to share an opinion regarding presidential job performance and their preference for control of the next Congress. The rate of disapproval for the president was lower than in national polls but did increase from 40% to 44% since the

fourth quarter of 2021. That's not too surprising. But the percentage of respondents favoring Democratic control of Congress increased from 33% to 36% over the past six months, leaving our respondents evenly divided about which political party they prefer to place in charge of legislation.

Recent legislative achievements may have garnered Democrats some good will. Alternatively, the decision in *Dobbs v Jackson Women's Health Organization*, which eliminated a constitutional right to obtain an abortion, might have played a role in the divergent survey results. President Joe Biden's job approval ratings appear to be having less of an impact on Congressional races than one might expect.



40% to 44%

Rate of disapproval for the president increased since the fourth quarter of 2021



33% to 36%

Percentage of respondents favoring Democratic control of Congress increased over the past six months

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Among other provisions, the IRA authorizes the Secretary of the Department of Health and Human Services to negotiate Medicare drug prices for 10 drugs that lack any competition from generics beginning in 2026. Other pharmaceuticals will be added annually thereafter. The IRA also extends the subsidies for insurance premiums under the Affordable Care Act for another three years. The new legislation will have a substantive impact on the US healthcare system, but its enactment precludes any additional changes to healthcare policy for the foreseeable future. From an investment standpoint, the impact of drug pricing on the pharmaceutical sector should be manageable from an earnings perspective. And importantly, clarity around drug pricing reform will remove a long-lasting overhang on the sector's valuations.

In terms of energy and climate, the Inflation Reduction Act provides USD 30 billion in tax credits to accelerate the production of renewable energy components. It also enhances the federal tax credit program for carbon capture use and sequestration, which directly benefits energy companies that can leverage CO2 capture technology for oil recovery. Public utilities, meanwhile, are incentivized to in-

crease renewable energy generation. Additional support for the energy sector might be on the agenda if Republicans assume control of one or both chambers of Congress, but additional investment in climate remediation is unlikely.

It is also worth noting that sustainable investing, more broadly, has become part of a national political debate. Some state governments have pushed back on investment initiatives tied to sustainable principles, while others have reaffirmed their commitment. We expect the debate to persist for some time. The Department of Labor is planning to issue final guidance for plan sponsors on the use of environmental, social, and governance (ESG) considerations when selecting pension plan options later this year, which may present headline-level risks for sustainable investing strategies.

In terms of paying for the bill, it will be partly funded by a new alternative minimum tax on companies that make more than USD 1 billion in profits and a 1% tax on share buybacks. Based on our estimates, the taxes should have a minimal 1% drag on S&P 500 earnings per share, though some companies will be more affected than others.

ElectionWatch virtual event

Event



Tom Naratil
Co-President
UBS Global Wealth
Management



Robert M. Gates
22nd United States
Secretary of Defense

Recent global events have ushered in a new era of geopolitics. Please join us for our first *ElectionWatch* event where special guest Robert M. Gates, former United States Secretary of Defense, will discuss the role of policymakers as we look to secure America's future.

Wednesday, 21 September 2022
1:00–1:30 PM ET

Stay tuned for our second event on 26 October 2022 from 1:00–1:30 PM ET

[Add to calendar](#) >

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

How to invest

Over longer time periods, there is no consistent relationship between control of the executive and legislative branches of government and market returns¹ (Fig. 3). Overall, stocks typically trade sideways prior to the election and then rise in subsequent months.

We believe monetary policy decisions from the Federal Reserve will be the key market driver this year, especially given our base case for limited fiscal spending in a gridlock scenario. As a result, we believe the market impact of the midterms will be muted and advise investors to avoid taking big directional bets in anticipation of the election results.

That being said, certain investment themes stand to benefit from the policy environment both heading into, and beyond, Election Day.

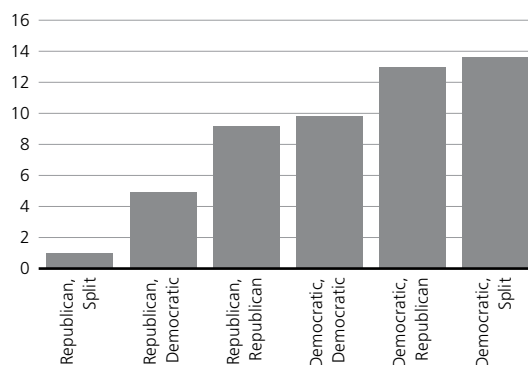
Greentech goes global

While new climate legislation would be unlikely under our base case of a divided government, funds already allocated from the recent IRA (Fig. 4) and last year's bipartisan infrastructure plan will continue to provide policy support for green investments. Several companies in the US region of the greentech theme are well positioned to benefit from both of these initiatives, especially those with exposure to grid infrastructure, environmental consulting, energy-efficient HVAC, sustainable aviation fuels, and related revenue streams.

Figure 3

No consistent relationship between market returns and makeup of politics

Average calendar year S&P 500 price return, in %



Source: Bloomberg, UBS, as of April 2022

Security takes center stage

Although gridlock would prove to be a setback for many legislative areas, investing in America's security across industries is not one of them. The CHIPS and Science Act, for example, passed on bipartisan grounds to secure the country's standing in the race for silicon nationalism. The Russian invasion of Ukraine and heightened geopolitical tensions with China have already had a meaningful and long-term impact on security considerations. Regardless of government composition, the policy environment should remain supportive overall when it comes to conventional defense spending and cyberspace, as well as securing energy, food, and semiconductor supplies.

Resilient spending

Select companies in our resilient spending theme should stand to benefit from already passed legislation, such as the bipartisan infrastructure plan and the Inflation Reduction Act. This includes companies that will receive government funding for green infrastructure, but also more traditional infrastructure such as roads, bridges, and ports.

For specific company ideas tied to these themes, please reach out to your UBS advisor.

Figure 4

Inflation Reduction Act '22: Budget estimates

Revenue and investment breakdown in USD

Total revenue raised	737bn
15 % corporate minimum tax	222bn*
Prescription drug pricing reform	265bn***
IRS tax enforcement	124bn**
1% stock buybacks fee	74bn*
Loss limitation extension	52bn*
Total investments	437bn
Energy security and climate change	369bn*
Affordable Care Act extension	64bn**
Western drought resiliency	4bn***
Total deficit reduction	300+ bn

Source: Democrats.senate.gov, Joint Committee on Taxation*, Congressional Budget Office**, Senate***, UBS estimates, as of August 2022

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Scenario analysis

We see three realistic possibilities in terms of election outcomes. The most probable scenario at this time is a divided Congress, with Democrats retaining narrow control of the Senate and the GOP assuming control of the House. The second most likely scenario is a unified Congress under Republican leadership. The third, which is less plausible but whose odds have increased over the past few weeks, is the retention of Democratic control of both houses. A fourth scenario—Democrats retaining control of the House but losing the Senate—is theoretically possible but highly unlikely.

Republican sweep

Additional climate investment is unlikely under the two most probable election outcomes, but greater support for the legacy energy sector is expected to be at the top of the agenda if the GOP assumes control of both chambers. A unified Congress is also more likely to increase defense spending significantly, while demanding budgetary reforms in exchange for increasing the debt ceiling.

Divided Congress

A divided Congress, with Democrats in control of the Senate and the GOP managing the flow of legislation to the floor of the House, increases the probability of partisan gridlock, a government shutdown, and a debt-limit showdown in 2023. Defense spending rises and support for the carbon energy sector increases. We expect House Republicans to leverage their control of congressional committees to exercise stringent oversight of the regulatory policies employed by the Biden administration. Bipartisan legislation is possible, but the scope of such agreement is limited.

Status quo

This scenario is less likely but can no longer be discounted completely, as Democrats have gained momentum this summer. This outcome would result in renewed efforts to amend the tax code, with a focus on the individual income tax rate and a global tax regime on corporations.

Legislative agenda

	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	25%	60%	15%
Election outlook	The probability of a GOP sweep has declined materially in recent weeks. GOP Senate candidates in some swing states appear more vulnerable than anticipated, while a recent Supreme Court decision to rescind federal constitutional protection for abortion motivated Democrats and unaffiliated voters to turn out in higher numbers in recent primary elections.	Unlike the Senate, where candidates run statewide and often enjoy high name recognition, the fate of candidates for the House is tied closely to the president's popularity. Biden's job approval ratings have improved in recent weeks, but we still expect the GOP to recapture control of the House and pursue a more conservative legislative agenda.	The probability of Democrats retaining control of the House is low. Midterm elections are notoriously challenging for the party holding the White House, and this year should prove to be no exception. The president's party usually loses at least two dozen seats in midterm elections. Current polls suggest the GOP may win fewer seats than usual but still enough to control the House.

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Fiscal policy implications

	Republican sweep	Divided Congress	Status quo
Taxes	If a bill to extend some popular tax breaks is not passed before year-end, Congress is expected to do so early in the next Congress. Some of these “extenders” enjoy bipartisan support. A retirement bill, which would include a higher age for minimum required distributions from investment retirement accounts, is also possible.	The tax extender bill also will be considered in a divided Congress if not passed in 2022. A GOP House is likely to introduce bills to reverse some provisions of the Inflation Reduction Act, but these bills would not receive a vote in the Senate.	A unified Congress under Democratic control would be a surprise. In that scenario, Democrats are likely to revisit marginal tax rates for individuals and push for the global minimum tax through reconciliation. Both provisions would require a larger margin of control in the Senate, however.
Defense	Spending increases significantly under this scenario. Bipartisan consensus on an adversarial posture toward China persists. The R&D tax credit is an important issue for the defense industry under all three scenarios.	Spending increases moderately. Bipartisan consensus on an adversarial posture toward China persists. The R&D tax credit is an important issue for the defense industry under all three scenarios.	Spending increases moderately. Bipartisan consensus on an adversarial posture toward China persists. The R&D tax credit is an important issue for the defense industry under all three scenarios.
Agriculture	An omnibus bill is enacted by Congress roughly once every five years. Current programs expire in September 2023. A new bill will pass, but the GOP may demand cuts to supplemental nutrition assistance programs.	The farm bill is too expansive to pass through budget reconciliation, so compromises must be struck to pass the 60-vote threshold in the Senate. A new bill will pass, but House Republicans may demand cuts to supplemental nutrition assistance programs.	Democratic majorities will focus on climate change, conservation programs, nutrition, and expanding opportunities for smaller producers.
Debt limit	Negotiations are likely to run close to the default deadline. The debt limit is raised, but the GOP demands some concessions on social spending. A unified Congress will make it marginally easier to raise the debt limit as the Senate leadership may be more motivated to strike a deal.	Negotiations are highly contentious before the default deadline, which may be difficult to resolve if the GOP’s margin of control is relatively narrow. The GOP demands concession on social spending.	The path to raising the debt limit is easier in the House, but the Senate will still require a compromise because of the threat of a filibuster.

Sector outlook



Financials

Bradley Ball, Financials Sector Strategist Americas

We believe a Republican sweep represents the most beneficial scenario for the financial services sector, as the GOP would resist efforts to constrain the activities of large financial institutions. Senior leadership at the regulatory agencies (FRB, OCC, SEC, CFPB, and FDIC) have been nominated and confirmed, but a GOP majority would be expected to oppose more stringent regulation and would hold hearings to challenge regulators’ efforts to promote more intrusive regulation. An attempt might be made in a unified Congress under GOP control to release government-sponsored enterprises from conservatorship.

In a divided Congress, the Democratic leadership in the Senate could continue to scrutinize large institutions and nonbank financial corporations. Regulatory agencies would continue to interpret the 2010 Dodd-Frank Act stringently, but new legislation affecting the financial services sector would be more limited. Proposed legislation on credit card interchange competition could advance in the Senate but is unlikely to gain traction in a Republican House.

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Sector outlook continued



Healthcare

Eric Potoker, Healthcare Sector Strategist Americas

Most legislation affecting the US healthcare industry is unlikely to make much headway if either chamber of Congress flips to Republican control. One possible exception may be legislation affecting pharmacy benefit managers. A more active regulatory posture by the executive branch could be negative for the healthcare sector compared to the status quo, but the Biden administration is likely to have its hands full focusing on the promulgation of regulations and may not have sufficient bandwidth to drive additional healthcare regulations. Regardless of the outcome in November, federal legislation governing the commercial sale and use of cannabis seems unlikely in the next Congress if the GOP takes control of either chamber.



Real estate

Jon Woloshin, Real Estate and Lodging Sector Strategist Americas

A Republican sweep could result in reduced legislative risk for landlords, with less scrutiny of single-family rental operators, potentially spurring the development of much needed additional housing units. Green subsidies for housing and stricter carbon emission rules for commercial real estate also are less likely in this scenario. The legislative push for additional green subsidies and faster carbon emission compliance is likely to slow down under a unified or split Congress.



Energy and utilities

Jay Dobson, Energy & Utilities Sector Strategist Americas

The Inflation Reduction Act included an array of provisions to address the impact of climate change and to make investments in renewable energy. The next significant energy bill is likely to focus on legacy energy infrastructure and pipeline-permitting reform, which was promised to Senator Joe Manchin in return for his support for the renewable energy titles found in the IRA. This legislation would attempt to streamline some of the permitting challenges that have plagued the development of energy infrastructure, such as the Mountain Valley Pipeline project. However, the legislation would face significant obstacles. Other energy legislation should be limited in either the Republican sweep or divided government scenario.



Industrials

Nathaniel Gabriel, Industrials Sector Strategist Americas

A unified Congress under Republican control would result in a larger budget for national defense, with fewer delays and the potential for new funding to incorporate programs on the unfunded priority list. Congress may also be more amenable to international weapons sales, adding to defense company backlogs. Political support for traditional fossil fuel production could encourage more private sector spending in the oil and gas complex, boosting the equipment manufacturers and service providers.

Support for a defense budget in excess of the president's 2023 request appears bipartisan, as evidenced by the easy passage of the USD 840 billion National Defense Authorization Act in the House. So, a split Congress should not result in a materially different outcome. The benefits from the Infrastructure Investment and Jobs Act should play out as expected, supporting industrial companies in traditional and clean energy infrastructure, but new infrastructure investments beyond those already envisioned are unlikely.



Information technology

Kevin Dennean, Technology and Communication Services Sector Strategist Americas

Traditional technology companies in the software, IT services, and semiconductor areas face few risks regardless of the outcome of the midterm elections. In a split Congress, House Republicans are expected to schedule hearings and could pursue legislation addressing privacy, but the odds of anything substantive passing before the next presidential election are low. The semiconductor industry has broad bipartisan support, so additional support in the form of a CHIPS Act, Part II is possible.



Communication services

Reid Gilligan, Media Sector Strategist Americas; Kevin Dennean, Technology and Telecom Sector Strategist Americas

Internet and social media platforms will likely continue to see increased scrutiny over privacy and content concerns, but little actual impact. While both parties opine on the need to regulate these platforms, they view the problem through very different lenses (i.e., bias vs. censorship), which has resulted in a sort of regulatory stalemate so far. We therefore believe a "clean sweep" of both legislative bodies as well as the executive branch is a prerequisite for material changes in regulatory policy. While nationwide broadband coverage is a focus of both political parties, we do not believe the election will impact the industry or the Broadband Equity Access Deployment program deployment in a major way.

Source: UBS

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Voters react to Supreme Court decisions

Alexander Hamilton asserted that an independent federal judiciary was bound to be the weakest of the three branches of government because it held “no influence over either the sword or the purse.”¹ In hindsight, he underestimated the impact of Supreme Court decisions on American society. The court’s influence on the daily lives of American voters has increased markedly over time. The most recent term was no exception, having delivered important decisions on topics ranging from abortion and environmental regulation to gun control and religious expression.

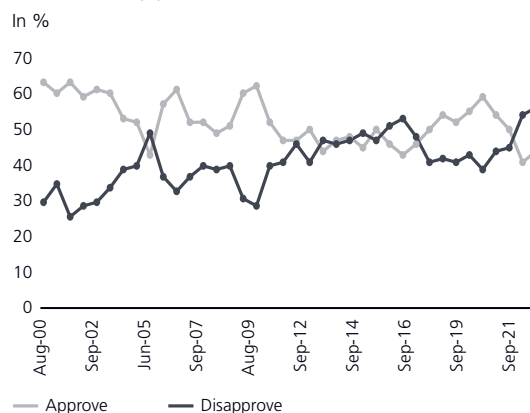
By and large, the Supreme Court has been viewed with greater deference than either Congress or the presidency, which has tended to dampen criticism of the institution over longer time periods. That may be changing. According to Gallup, the court’s overall approval rating has been on a downward

trajectory for more than 20 years.² More ominously, the partisan divide appears to have widened.³ (Figs. 5 and 6). In a national poll conducted by Grinnell College in October 2021, 62% of the respondents believed that justices’ political views drive their decisions.⁴

As we discussed in our 21 April *ElectionWatch* report, “The balance of power,” voters tend to view midterm elections as a referendum on the incumbent president’s performance, and those affiliated with the opposition party are generally more motivated to cast a ballot. Recent Supreme Court decisions have the potential to provoke registered Democrats and unaffiliated registered voters, otherwise indifferent to an unpopular president, to vote in greater numbers than the historical pattern would suggest.

Figure 5

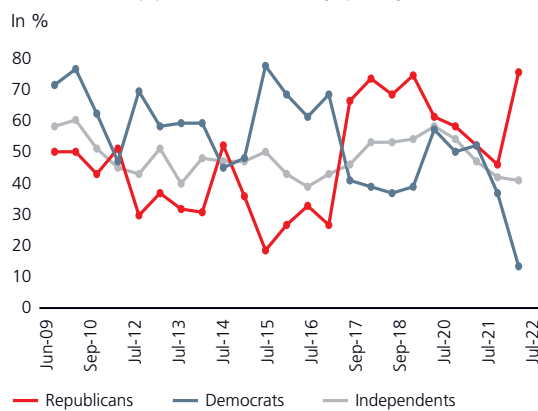
SCOTUS approval rates



See Gallup <https://news.gallup.com/poll/395387/democrats-approval-supreme-court-record-low.aspx>
Source: Gallup, as of 2 August 2022.

Figure 6

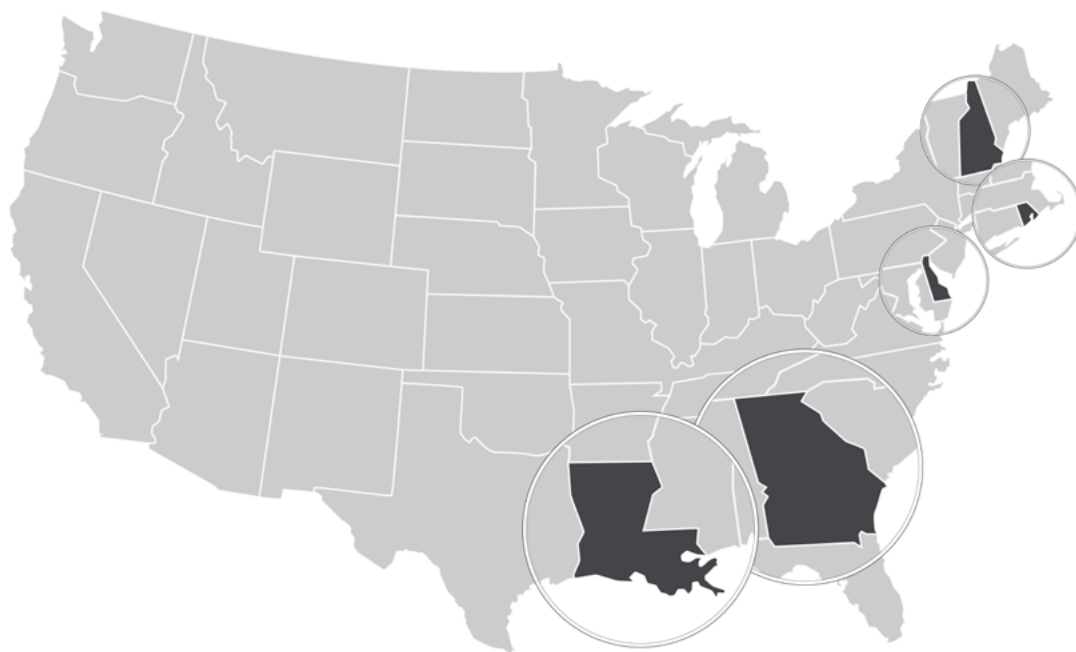
SCOTUS approval rates by party affiliation



See Gallup <https://news.gallup.com/poll/395387/democrats-approval-supreme-court-record-low.aspx>
Source: Gallup, as of 2 August 2022.

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Midterms timeline



<p>13 September</p> <ul style="list-style-type: none"> • Delaware primary election • New Hampshire primary election • Rhode Island primary election 	<p>8 November</p> <ul style="list-style-type: none"> • Election Day • Louisiana open primaries 	<p>6 December</p> <ul style="list-style-type: none"> • Georgia runoffs 	<p>10 December</p> <ul style="list-style-type: none"> • Louisiana runoffs
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Source: CNN, Ballotpedia

2	State of the race
3	A consequential summer
6	How to invest
7	Scenario analysis
10	Voters react to Supreme Court decisions
11	Midterms timeline
12	Appendix

Appendix

Endnotes to “A consequential summer”

¹ There have been only three instances (1934, 1998, and 2002) in the past century where the president’s party did not lose seats in the House in the midterm elections.

² Matt Spetalnick and Steve Holland, “Subdued Obama says suffered a voter shellacking,” Reuters, 2 November 2010. Reuters reported former president Obama as saying, “Now I’m not recommending to every future president that they take a shellacking like I did last night. I’m sure there are easier ways to learn these lessons.”

³ Association of American Medical Colleges, “Health Care Costs: What’s the Problem?” 17 August 2022.

Endnotes to “UBS Investor Sentiment survey”

¹ *ElectionWatch*, “More clarity, more uncertainty,” 25 March 2022. See also Maarten Meeuwis and Jonathan Parker, et al., “Belief Disagreement and Portfolio Choice,” National Bureau of Economic Research, Working Paper 2510, September 2019; Yosef Bonaparte and Alok Kumar, et al., “Political Climate, Optimism, and Investment Decisions,” University of Miami, 26 February 2012; Marian Moszoro, “The Party Politics of Stock Market Investing,” George Mason University, 25 March 2019; Harrison Hong and Leonard Kostovetsky, “Red and Blue Investing,” Princeton University, March 2010; and Babajide Wintoki and Yaoyi Xi, “Political Partisan Bias in Mutual Fund Portfolios,” University of Kansas, May 2017.

Source: August ‘22 UBS Investor Sentiment. Based on online survey of investors with USD 1M+ investable assets and business owners with USD 1M+ annual revenue and at least one other employee (sample size US 1,397) from August 5 – 19, 2022.

Endnotes to “How to invest”

¹ *ElectionWatch*: “The balance of power,” published on 21 April 2022.

Endnotes to “Voters react to Supreme Court decisions”

¹ Alexander Hamilton, Federalist Paper No. 78, 28 May 1788.

² Mohamed Younis, “Democrats’ Approval of Supreme Court at Record Low,” Gallup, 2 August 2022.

³ Ibid.

⁴ Grinnell College National Poll, conducted 13–17 October 2021 by Selzer and Company on behalf of Grinnell College; results and findings released on 20 October 2021. The poll indicated that 60% of Republicans, 66% of Democrats, and 63% of independents said they believed that politics drove Supreme Court decisions.

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