Re-setting the stage for the 2022 midterm election

Executive summary

The 2022 midterm elections are less than five weeks away, with polls and prediction markets forecasting a much different outcome than contemplated just three months ago. Prediction markets now expect Democrats to retain control of the Senate while Republicans retake the House, but the political landscape remains fluid in the runup to November 8, 2022.

If voters award Republicans control of either the U.S. Senate or House of Representatives splitting control of Congress (54% odds as of October 3, according to Predictit.org, an online political and event prediction market platform), we expect relative continuity on tax policy. However, this scenario likely means marginally less fiscal stimulus. Additionally, Republicans winning control of both the Senate and the House (34% odds) creates a headwind to the President's agenda, including delaying or blocking presidential appointees in the Senate. The combination of a Republican controlled House and Senate with a Biden White House would likely result in more legislative brinkmanship, with President Biden utilizing executive action and exercising his veto power.

If Democrats retain control of Congress, holding onto the House and potentially adding to their Senate majority (12% odds), odds improve for taxation and spending changes and passage of more Democrats' policy agenda elements, including unpassed components of the Biden Administration's Build Back Better framework.

Turning to market history, U.S. equities — measured by the S&P 500 Index — usually underperform average returns in the runup to midterm elections and outperform after their conclusion. Typically, the fiscal policy path becomes cloudy ahead of the midterm election due to the potential for leadership and membership changes. After the election, leadership and the fiscal agenda are clear, providing a foundation for improving investor sentiment. However, this pattern does not explain all past market outcomes around midterm elections we studied. Equities have at times provided above-average returns in the 12 months before a midterm. From this we conclude that the prevailing economic environment matters a great deal more than any temporary policy uncertainty to capital market performance.

Setting the stage

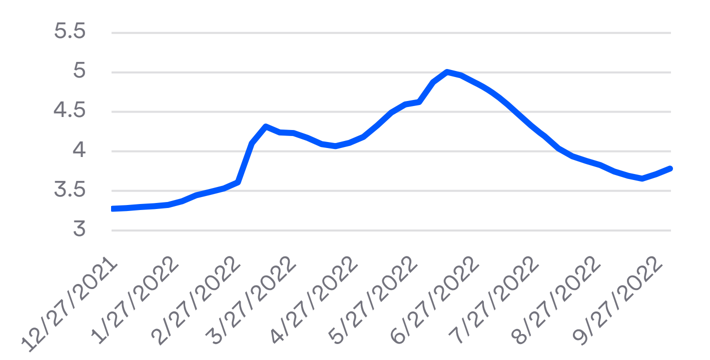
Congressional midterm elections often serve as a referendum on the party holding the White House. In our historical review, a first-term president's party usually loses congressional seats at the midterm election, often in the House of Representatives. Historically, lost support for the President's party reflects disappointment with the president's agenda or a perceived failure to confront economic or global challenges. However, several polarizing political events as well as inflation trends leading up to this November's election complicate the typical historical pattern, suggesting that voters' general party affiliation and presidential candidate preferences may exert a greater influence than observed in past midterm elections.

First, Democratic voters appear energized in the wake of the Supreme Court's June 24 decision in the Dobbs v. Jackson Women's Health case, and to a greater extent than Republicans. Prior to the decision, Real Clear Politics' generic Congressional vote indicated a 3.4% Republican advantage; post-Dobbs, the advantage has narrowed to a 1.0% Republican advantage as of October 3.

Second, the Federal Bureau of Investigations (FBI) executed a search warrant related to classified documents held at former President Donald Trump's Mar-a-Lago Florida residence on August 8. While the investigation remains ongoing, it elevated the former president to front page headlines, suggesting midterm elections may now reflect a more generic voter choice between two potential 2024 presidential candidates rather than as a referendum on President Biden's first two years in office.

Finally, declining gasoline prices coincided with an improvement in President Biden's job approval ratings. The average retail unleaded gasoline price hit a record high of $5.01 per gallon in the week ending June 13 and President Biden's job approval, according to Real Clear Politics, registered 38.9%. Since June 13, gasoline prices dropped 24% to $3.78 per gallon; President Biden's approval rating touched a low of 36.8 on July 21 and has since improved to 42.1, still below 50% but a marked improvement from June and July and positive momentum heading into the November election.

Average retail gasoline price

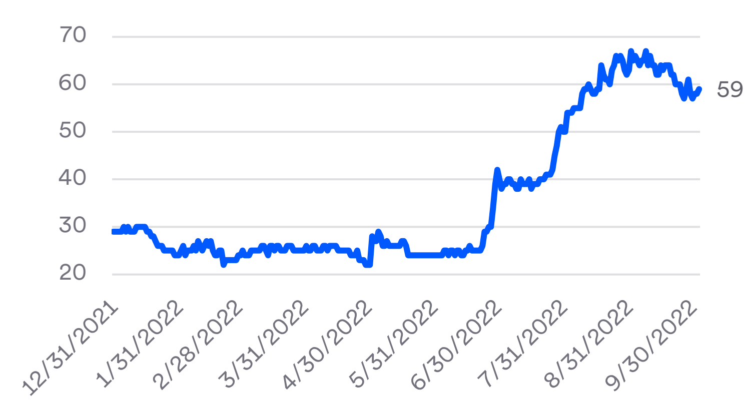


President Biden approval rating

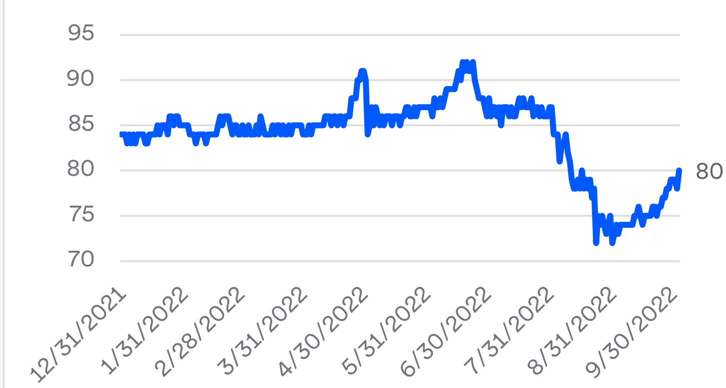
Current odds

Predictit.org places Republican chances of winning the U.S. House at 80% as of October 3, 2022, a 10% drop since the Supreme Court's Dobbs decision on June 24. Meanwhile, the odds that the Democrats will retain Senate control have improved dramatically, from 25% in June to 59% as of October 3. According to Gallup's July poll, voters' top concerns facing the country remain inflation, with June's Consumer Price Index (CPI) hitting a 40-year high of 9.1%, and satisfaction with the government's leadership. However, voters' concerns regarding the country's leadership and potential Russia/Ukraine conflict outcomes have receded in recent months, with a commensurate rise in voters' judiciary-related concerns.

PreditcIt odds of Democratic Senate



PredictIt odds of Republican House



Potential outcomes

Midterm election results can have a large impact on legislative policy's path in Washington. Possible election outcomes this fall include the Republicans regaining control of both the House and the Senate, Republicans winning either the House or Senate but not both, and Democrats retaining control of both houses, which would be a material divergence based on historical precedent.

Potential outcome #1: Republicans gain control of both the House and Senate

Should Republicans win both the House and Senate, legislative gridlock and a more limited range of tax policy are likely outcomes. For example, a Republican House and Senate will probably oppose attempts by the Biden Administration to implement major policy initiatives including significant corporate and individual tax increases. President Biden could pursue some executive orders and actions outside Congress under this scenario. However, the Senate can block nominations to the executive branch for agencies issuing these rules or implementing these orders. Further, many of these actions could face challenges in the courts, such as the Biden Administration's recent student loan debt relief plan. A Republican-controlled House and Senate would likely enact only must-pass legislation such as government funding or a national defense authorization act.

Potential outcome #2: Republicans gain control of either the House or the Senate

Republican control of the House of Representatives alone still provides Republicans the ability to originate spending bills. House control also gives GOP politicians subpoena power to investigate the White House, a political tactic seen during both the Obama and Trump administrations. Such investigations historically have little to no capital market impact but could hamper the implementation of President Biden's future policy agenda, leading to greater continuity of existing policy.

More consequentially, Republicans winning control of the U.S. Senate reduces chances that President Biden receives approval for remaining nominees that require Senate confirmation. This could include judges, Federal Reserve officials and officials overseeing powerful regulatory bodies.

Potential outcome #3: Democrats retain control of both the House and the Senate

A potential Democrat victory retaining control of both houses of Congress is not the most likely outcome in prediction markets. However, it is no longer as remote a possibility as the scenario appeared in June when markets predicted a 90% chance Republicans would retake the House and 75% odds of recapturing the Senate. A Democrat sweep result would represent a historical outlier event (only once in the past 15 midterm elections) and turn attention back toward a potentially more sweeping policy agenda. A scenario where Democrats retain control of the House while also gaining several seats in the Senate reduces or eliminates the ability for individual senators such Joe Manchin (D-WV) or Krysten Sinema (D-AZ) to hold up legislation. This scenario re-opens the potential for a fuller range of policy outcomes, such as revisiting the full "Build Back Better" legislative package of expanded social services, corporate and individual tax increases, additional clean energy investments and subsidies, and raising or eliminating the cap on state and local income tax deductions.

The three potential outcomes of the 2022 midterm elections

Election result	Policy result
Republicans win House or Senate	Limits major tax and spending policy changes
Republicans win both House and Senate	Strong headwind for White House agenda, legislative gridlock and brinkmanship
Democrats retain both House and Senate	Democrats press forward with key initiatives, potentially revisiting "Build Back Better" agenda items

Source: U.S. Bank analysis, September 2022.

Near-term policy implications

Congress's top priority prior to the midterms was funding the federal government. The most recent appropriations bill was signed into law on March 15 and covered spending through the government's fiscal year, which ended on September 30. Congress passed a Continuing Resolution (CR) to temporarily fund the government through December 16, alleviating a government shutdown risk as both parties appear focused on highlighting key policies and events galvanizing their respective voting bases rather than creating a distraction from voters' core concerns.

Capital market implications

Historically the economy's trend drives broad equity market performance more than midterm election results, though we often see impacts to specific sectors or industries. Our analysis of market performance based on congressional party control since 1962 found the specific party controlling Congress historically has no statistical edge in overall equity market performance relative to long-term averages. However, midterm elections coincide with unique market performance.

Using data compiled from Bloomberg, we find the S&P 500 Index underperforms average returns for all periods in the 12 months leading up to midterm elections and outperformed average returns for the 12 months post-midterm election. Specifically, the average 12-month S&P 500 Index performance starting October 31 is 8.0% since 1961. The same 12-month period pre-midterm election returned an average of -1.1% out of a sample size of 16 occurrences. The 12-month period post-midterm election returned an average of 16.3% in the 15 midterm elections since 1962. The three- and six-month periods following midterm elections also exhibit significant historical outperformance relative to years with no midterm election.

What explains this phenomenon? A key factor may involve higher policy uncertainty before midterm elections, which turns into policy certainty after the midterm. Since 1939, the S&P 500 Index has not experienced negative absolute price returns during the full year after a midterm election. Of course, 1939 returns revolved around changing central bank policy, the economic backdrop of a country still in the Great Depression and enhanced geopolitical risk only two years before America entered World War II. This suggests the current macroeconomic environment carries far greater weight on returns than policy certainty or uncertainty.

A closer look at pre-midterm equity market underperformance drives this point home further. Below average pre-midterm performance dissipated in the last two decades as the economy grew steadily, central bank policy held interest rates low, supporting low borrowing costs, and inflation remained below long-term averages. Negative pre-midterm returns were predominant in the 1960s and 1970s and once again are manifesting in the current period, weighing significantly on the pre-midterm average. Excluding the five midterms in the 1960s and 1970s and the current period increases the performance in the 12 months before a midterm to 8.1%, roughly in line with average annual S&P 500 performance.

Midterm election year stock market performance since 1962

Year	President	Party	President's party: House seats	President's party: Senate seats	Before-midterm S&P 500 price performance Nov. 1-Oct. 31 (12 months)**	S&P 500 price performance Nov. 1-Jan. 31 (3 months)	S&P 500 price performance Nov. 1-Apr. 30 (6 months)	S&P 500 price performance Nov 1.-Oct. 31 (12 months)
1962	John Kennedy	D	-4	+3	-17.6%	17.1%	23.5%	30.9%
1966	Lyndon Johnson	D	-47	-4	-13.2%	8.0%	17.2%	17.1%
1970	Richard Nixon	R	-12	+2	-14.4%	15.1%	24.8%	13.0%
1974	Gerald Ford (Nixon)	R	-48	-5	-31.8%	4.2%	18.1%	20.5%
1978	Jimmy Carter	D	-15	-3	0.9%	7.3%	9.2%	9.3%
1982	Ronald Reagan	R	-26	+1	9.7%	8.7%	23.0%	22.3%
1986	Ronald Reagan	R	-5	-8	28.5%	12.3%	18.2%	3.2%
1990	George Bush	R	-8	-1	-10.7%	13.1%	23.5%	29.1%
1994	Bill Clinton	D	-52	-8	1.0%	-0.4%	9.0%	23.1%
1998	Bill Clinton	D	5	0	20.1%	16.5%	21.5%	24.1%
2002	George W. Bush	R	8	+2	-16.4%	-3.4%	3.5%	18.6%
2006	George W. Bush	R	-30	-6	14.2%	4.4%	7.6%	12.4%
2010	Barack Obama	D	-63	-6	14.2%	8.7%	15.2%	5.9%
2014	Barack Obama	D	-13	-9	14.9%	-1.1%	3.3%	3.0%
2018	Donald Trump	R	-40	+2	5.3%	-0.3%	8.6%	12.0%
2022	Joe Biden	D	?	?	-22.1%			
Average seat change:			-23	-3				
Midterm average:					-1.1%	7.3%	15.1%	16.3%
Non-midterm average*:					11.2%	2.8%	3.9%	5.8%

Flip to Republican control (red) | Flip to Democrat control (blue)

Data source: Bloomberg data, Oct. 31, 1961 to Oct. 3, 2022.
* The average monthly price return of the S&P 500 in three-month, six-month and 12-month increments, starting in the month of November of every year since 1963 where there wasn't a midterm election held in that November.
** The average 12-month price return of the S&P 500 in the 12 months preceeding a midterm election, where the last date of the price close as of Oct. 31 is several days before the November midterm election. 2022 as of October 3.

Conclusion

In November's midterm elections, polls and prediction market odds still point to Republicans regaining the House, but their odds fell recently due to several policy events and cheaper gasoline prices. Republicans gaining control of both the Senate and House presents a large headwind to President Biden's agenda, though some limited opportunities for bi-partisan agreement remain and the White House could still pursue some executive orders and rulemaking with industry-specific impacts. A Republican victory to gain either body of Congress will likely result in relative legislative gridlock. Odds that Democrats retain both the Senate and House are no longer a remote possibility; a Democrat sweep including Senate gains re-opens the potential for large taxation and spending changes and further passage of Democrats' policy agenda, including unpassed components of the Biden Administration's Build Back Better framework.

U.S. equity markets tend to underperform average returns in the 12 months before midterm elections and outperform average returns in the 12 months after. One possible explanation is increased fiscal policy uncertainty before the midterm election resolved by a greater degree of certainty afterward. Yet, a closer examination of equity market performance surrounding midterm elections shows the economic backdrop has the greatest impact on equity returns.

The Federal Reserve and other major central banks are transitioning from pro-growth to more restrictive monetary policies amid persistently elevated inflation, most recently evidenced by the Fed's third consecutive larger-than-normal 0.75% rate hike at the conclusion of its regularly scheduled meeting on September 21. With the Federal Reserve transitioning toward increasingly more restrictive monetary policy in 2022, we continue to anticipate more capital market volatility in the runup to the midterm election. Underlying economic fundamentals, including consumer and corporate balance sheets, remain strong and if these fundamentals persist, the impact of greater policy uncertainty is likely limited. While we and our U.S. Bank Economics Team are not anticipating a significant growth slowdown, we do see the risk of weakening economic momentum feeding into consumer and business activity. We continue to monitor capital markets for favorable risk/rewards for clients and we will update you on developments as they unfold. We encourage you to use every opportunity to engage with your U.S. Bank counterpart should you have any questions about your unique situation and please do not hesitate if we can answer specific questions or help in any way.

This information represents the opinion of U.S. Bank Wealth Management. The views are subject to change at any time based on market or other conditions and are current as of the date indicated on the materials. This is not intended to be a forecast of future events or guarantee of future results. It is not intended to provide specific advice or to be construed as an offering of securities or recommendation to invest. Not for use as a primary basis of investment decisions. Not to be construed to meet the needs of any particular investor. Not a representation or solicitation or an offer to sell/buy any security. Investors should consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. U.S. Bank is not affiliated or associated with any organizations mentioned.

Based on our strategic approach to creating diversified portfolios, guidelines are in place concerning the construction of portfolios and how investments should be allocated to specific asset classes based on client goals, objectives and tolerance for risk. Not all recommended asset classes will be suitable for every portfolio. Diversification and asset allocation do not guarantee returns or protect against losses.

Past performance is no guarantee of future results. All performance data, while obtained from sources deemed to be reliable, are not guaranteed for accuracy. Indexes shown are unmanaged and are not available for direct investment. The S&P 500 Index consists of 500 widely traded stocks that are considered to represent the performance of the U.S. stock market in general.

Equity securities are subject to stock market fluctuations that occur in response to economic and business developments. International investing involves special risks, including foreign taxation, currency risks, risks associated with possible differences in financial standards and other risks associated with future political and economic developments. Investing in emerging markets may involve greater risks than investing in more developed countries. In addition, concentration of investments in a single region may result in greater volatility. Investing in fixed income securities are subject to various risks, including changes in interest rates, credit quality, market valuations, liquidity, prepayments, early redemption, corporate events, tax ramifications and other factors. Investment in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in lower-rated and non-rated securities present a greater risk of loss to principal and interest than higher-rated securities. Investments in high yield bonds offer the potential for high current income and attractive total return, but involve certain risks. Changes in economic conditions or other circumstances may adversely affect a bond issuer's ability to make principal and interest payments. The municipal bond market is volatile and can be significantly affected by adverse tax, legislative or political changes and the financial condition of the issues of municipal securities. Interest rate increases can cause the price of a bond to decrease. Income on municipal bonds is free from federal taxes, but may be subject to the federal alternative minimum tax (AMT), state and local taxes. There are special risks associated with investments in real assets such as commodities and real estate securities. For commodities, risks may include market price fluctuations, regulatory changes, interest rate changes, credit risk, economic changes and the impact of adverse political or financial factors. Investments in real estate securities can be subject to fluctuations in the value of the underlying properties, the effect of economic conditions on real estate values, changes in interest rates and risks related to renting properties (such as rental defaults).

U.S. Bank and its representatives do not provide tax or legal advice. Your tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation.