Situation analysis

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Setting the stage for the 2022 midterm election

Executive summary

Though the 2022 midterm remains eight months away, U.S. policymakers are shifting their focus to the election with President Biden's "Build Back Better" legislation faltering amid opposition within the majority Democratic Party. Prediction markets expect Republicans to win control of Congress, but the political landscape can change significantly between now and November 2022.

If Republicans win control of either the U.S. Senate or House of Representatives, we expect relative continuity on taxation policy. However, Republican control of either the Senate or House with a Democratic White House likely means marginally less fiscal stimulus. Additionally, Republican control of both the Senate and the House create a headwind to the President's agenda, including delaying or blocking presidential appointees in the Senate. The combination of a Republican Congress and a Biden White House could enact some limited bipartisan legislation, similar to the recently passed infrastructure spending package.

If Democrats retain control of Congress, odds improve for passing the full Democratic agenda, including components of President Biden's Build Back Better plan. Democratic control of Congress after the midterms also greatly increases the odds of more significant changes to tax and spending policy, including individual and corporate tax increases.

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 path of fiscal policy becomes cloudy ahead of the midterm election due to the potential for changes in leadership and membership. 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 elections between Presidential elections, commonly called midterms, often operate as a referendum on the party holding the White House. In our review of history, we typically see the party of a first-term president lose congressional seats at the midterm election, often in the House of Representatives. Disappointment with the new president's agenda or the perception that policies fail to confront economic or global challenges are historically drivers of lost support.

In the wake of the President's State of the Union address, his approval rating stands at just 40.9% (March 2, 2022, Real Clear Politics Poll Average), having fallen from 55.8% since January 30, 2021. His legislative agenda lost momentum after Democratic Senator Joe Manchin withdrew support for the President Biden's "Build Back Better" legislative package of expanded social services, increased clean energy spending and tax policy changes including corporate and individual increases. The loss of Senator Manchin's vote eliminated the narrow edge the administration held in the evenly divided Senate. Disagreements within the Democratic Party over strategy and

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direction further undermine the President's power and agenda. As the midterms draw closer, Congress may increasingly shift toward campaigning and away from legislating.

Predictit.org, an online political and event prediction market platform, places Republican chances of winning the U.S. House at 85% as of March 3, 2022. The odds of GOP control of both the House and Senate stand at nearly 74% percent,[1] though these odds can significantly change before November's election. According to the Wall Street Journal, polls indicate voters are primarily concerned about inflation,[2] with the Consumer Price Index (CPI) climbing 7.5% over the past year ending in February and gasoline prices at the highest level in seven years. An easing in supply constraints and easing of inflation pressures could reduce this issue's importance as the election nears. Other risks, such as the ongoing coronavirus pandemic, higher borrowing costs from changes in Federal Reserve monetary policy or emerging geopolitical issues could move to the forefront.

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.

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 reject any significant corporate and individual tax increases. A Republican victory gaining both the House and the Senate also limits the President's ability to execute his preferred agenda. 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. This creates an even greater possibility that gridlock ensues outside of industry-specific areas where the president can impact policy — such as automobiles through increases in Corporate Average Fuel Economy (CAFE) standards, Medicare, trade policy and antitrust. A unified Republican Congress with a Democratic White House would likely focus on policies with limited bipartisan agreement, as we saw with infrastructure spending.

Republican control of the House of Representatives alone still provides Republicans the ability to originate spending bills. Control also gives GOP politicians subpoena power to investigate the White House — a political tactic seen during both the Obama and Trump administrations. These investigations are unlikely to have any capital market impact but could hamper the implementation of President Biden's full 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 his nominees that require senate confirmation. This could include judges, Federal Reserve officials and officials overseeing powerful regulatory bodies such as the Federal Trade Commission (FTC).

A surprise Democrat victory to hold both the House and Senate would turn attention back toward President Biden's policy agenda, including the full "Build Back Better" legislative package of expanded social services, clean energy investments and subsidies, raising or eliminating the cap on state and local income tax deductions, and corporate and individual tax increases.

[1] Predict It, March 3, 2022.
[2] "Inflation Emerges as a Key Concern for Voters, WSJ Poll Finds," Wall Street Journal, Dec. 7, 2021

The three potential outcomes of the 2022 midterm

Election result	Policy result
Republicans win House or Senate	Limits major changes to tax and spending policy
Republicans win both House and Senate	Strong headwind for White House agenda but also chances for some limited bipartisan agreement
Democrats retain both House and Senate	Democrats press forward with key initiatives, including remaining "Build Back Better" agenda items

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

Capital market implications

The 2022 midterm election results are unlikely to drive broad equity market performance, though we could see impacts to specific sectors or industries. We analyzed market performance based on congressional party control since 1962. We found the specific party controlling Congress historically has no statistical edge in overall equity market performance, relative to long-term averages. However, the occurrence of a midterm election historically does coincide with unique market performance.

According to data compiled from Bloomberg, the S&P 500 Index has historically underperformed average returns in the year prior to midterm elections and outperformed average returns in the 12 months after midterm elections.[3] Specifically, the average 12-month S&P 500 Index performance starting October 31 is 8.1 percent since 1961. The same 12-month period pre-midterm election returned an average of 0.3% out of a sample size of 15 occurrences. The 12-month period post-midterm election return an average of 16.3% in the 15 midterm elections since 1962. The one- and three-month periods following midterm elections also exhibit significant historical outperformance relative to years with no midterm election.[4]

What explains this phenomenon? A key factor may involve higher policy uncertainty before midterm elections that develops into policy certainty after the midterm. In fact, the S&P 500 Index has not experienced negative absolute price returns during the full year after a midterm election since 1939.[5] 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 economy and a healthy macroeconomic environment carry 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 concentrate in the 1960s and 1970s, which weigh significantly on the pre-midterm average. Excluding the five midterms in the 1960s and 1970s increases the performance in the 12 months before a midterm to 8.1%, roughly in line with average annual S&P 500 performance.

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[3] Looking at 12-month periods where the price return is the closing price on October 31.

[4] See table on page 4.

[5] Analysis of the 1938 midterm is not included in the table.

Midterm 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 F. 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%
Midterm average					**0.3%**	**7.3%**	**15.1%**	**16.3%**
Non-midterm average*					**10.7%**	**2.9%**	**4.2%**	**6.4%**
Average seat change			**-23**	**-3**				

(red)	Flip to Republican control
(pink)	Flip to Democrat control

Data source: U.S. Bank Asset Management Group research, Bloomberg, October 31, 1961-December 31, 2021.
*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 October 31 is several days before the November midterm election.

Conclusion

In November's midterm elections, polls and prediction market odds indicate Republicans will make significant gains and could win both the Senate and the House. A Republican victory to gain either body of Congress will likely result in relative legislative gridlock. Republicans gaining control of both the Senate and House presents a large headwind to President Biden's agenda, though the White House could then pursue some executive orders and rule-making, which have industry-specific impacts. Democrats retaining both the Senate and House means relatively large taxation and spending changes and further passage of Democrats' policy agenda, including unpassed components of Build Back Better.

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. A possible explanation is increased fiscal policy uncertainty before the midterm election resolved by a greater degree of certainty afterward. For example, in the next eight months midterm odds can change significantly, which changes the odds of various policy outcomes in 2023 and

2024. Yet a closer examination of equity market performance surrounding midterm elections shows the economic backdrop has the greatest impact on equity returns.

Pro-growth central bank policies, low interest rates and a liquidity-driven capital market backdrop have provided a strong tailwind to equity performance since March 2020. With the Federal Reserve transitioning toward more restrictive monetary policy in 2022, we could see greater market volatility in the runup to the midterm election. Underlying economic fundamentals including consumer and corporate balance sheets are strong. If these fundamentals persist, the impact of greater policy uncertainty is likely limited. We will update you on developments and encourage you to engage with your investment professional should you have any questions about your unique situation.
