First Trust Portfolios Canada
Monday Morning OUTLOOK

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Beware a "Gridlock Rally"

Election day is tomorrow and will bring results for key Senate, House, and Governors races from all around the country, plus local legislative races and more. For the federal races, our projection is that the Republicans are essentially a slam-dunk to take back the House of Representatives (98% likely) and very likely to take back the Senate (about 80%).

To be exact, our best guesses are that the GOP will end up with around 53 seats in the Senate (which, if exactly right, would be a gain of 3) and 240 in the House (which would be a gain of 28 seats compared to where the GOP finished in 2020). We're confident we won't get this exactly right, but, as of today, that's how we see the races breaking.

If you want a scorecard for the Senate races, we suggest focusing on five elections, in particular: New Hampshire, Pennsylvania, Georgia, Arizona, and Nevada. To keep the Senate, the Democrats need to win at least four of those five races. Not impossible, but very unlikely; we're projecting they win only one of these, not four. In particular, if the Republicans win New Hampshire, they are also likely to win at least one of those other four states (and, therefore, Senate control), you might be able to go to bed early tomorrow night.

If we're right about the election outcomes, or even close, many stock market investors might take it as a reason to be bullish. The result would be "gridlock," which means no major federal legislation could be enacted unless it got significant bipartisan support.

Gridlock has been good for stock market investors in the past few decades, particularly when there's been a Democratic president and the Republicans in control of at least one house of Congress. For example, under President Clinton, from the market close on election night 1994 – when the Republicans took control of both houses of Congress for the first time in forty years – to the end of the Clinton presidency, the S&P 500 generated a total return of 20.7% per year. Under President Obama, from the close on Mid-Term Election Night 2010 – when the GOP took the House and made gains in the Senate – through the end of his presidency, the S&P 500 generated a total return of 13.3% per year.

But there are some big differences between the current economic situation and those other two episodes. In November 1994, consumer price inflation (on a year-ago comparison basis) was running at 2.7%; in November 2010, the CPI was running at 1.1%. Right now, inflation is running north of 8.0%, and the Fed is ratcheting up rates no matter who wins.

Back in the 1990s, theoretical "gridlock" ended up being a mirage, as President Clinton and congressional Republicans ended up agreeing on welfare reform, trimming Medicare, cutting the capital gains tax, and expanding free trade. If scandal hadn't interceded late in the Clinton presidency, even Social Security reform would have been possible. President Obama and congressional Republicans agreed on much less, but "gridlock" meant no more expansion of entitlements, like health care, and did result in a compromise that extended much of the Bush tax cuts originally enacted in 2001-03.

If the stock market soon rallies broadly because investors think a current episode of gridlock under a Democratic president will end up looking like the last two, we think they end up disappointed; the rally will fade, just like the bear-market rally we had this past summer (mid-June to mid-August).

This doesn't mean investors should ignore the election results. Who wins and loses should have an influence on which ***sectors*** might do better for at least the next couple of years. But expecting a quick and broad end to the bear market is expecting too much.

The same goes for a rally that might materialize if and when the Federal Reserve stops raising short-term interest rates next year. Yes, investors might bid up stock prices initially in relief. But that rally should fade, as well.

Ultimately, the stock market will be dominated not by election results but by fundamentals. Higher interest rates have been the key headwind for stocks this year; next year it's likely to be weaker profits as the "sugar high" of stimulus fades.

The election results tomorrow are unlikely to have an effect on interest rates or corporate profits in 2023. Meanwhile, President Biden is very unlikely to start cutting tax rates, government spending, or regulations that impede energy production. Vetoes and Executive Orders are more likely.

If you like one political side or another, we're sure tomorrow will give you reasons to cheer or jeer. But don't let your personal political preferences cloud your judgement. The bear market has further to go and a recession is highly likely in the next 18 months, no matter what the outcome.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
10-10 / 7:30 am	Initial Claims – Oct 8	220K	**218K**		217K
7:30 am	CPI – Sep	+0.6%	**+0.7%**		+0.4%
7:30 am	"Core" CPI – Sep	+0.5%	**+0.5%**		+0.6%
10-11 / 9:00 am	U. Mich Consumer Sentiment- Nov	59.5	**59.9**		59.9