

Exchanges at Goldman Sachs

Breaking Down the U.S. Midterm Elections: What's Next

for Policy, Markets and Economic Growth

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Allison Nathan: It's Wednesday afternoon, November 9th, and the vote count continues from Tuesday's US midterm elections. But after all races are called, what will the results mean for policy, markets, and economic growth?

Alec Phillips: A divided government just makes it less likely that they're able to get any kind of fiscal package or recession-fighting package done in a divided Congress. And then number two, that if they do do it, it would probably be pretty small. And I'd imagine it would be smaller than what we've seen in the last three recessions.

Allison Nathan: I'm Allison Nathan, and this is

Exchanges at Goldman Sachs.

The next Congress will call the shots on a range of critical issues. Joining me today to break down the results and implications of the US midterm elections are Alec Phillips, Goldman Sachs Research's chief US political economist, and Joe Wall, a managing director in our office of government affairs. Alec, Joe, thanks for joining us for this special edition of Exchanges.

Joe Wall: Thanks for having us.

Alec Phillips: Glad to be here.

Allison Nathan: Let's just start out by framing what we're seeing so far in these races. Joe, give us a sense of some of the outcomes and how they compare to expectations.

Joe Wall: Yeah. The expectations, as most of the listeners I'm sure are fairly aware, is that we were going to see a red wave, both in terms of the House flipping to Republican control in the magnitude of the net gain probably in the neighborhood of 20-plus seats. And then

on the Senate side, the view was that Republicans going into yesterday, Tuesday, were definitely favored to win control of the Senate. A little bit unclear in terms of how many seats, but it felt like they were going to gain anywhere from one to three.

So the facts that, as we sit here today, Wednesday afternoon, that the House has still not been officially called. It's all but certain, I think at this point, though, that Republicans will win control of the House. But the margins that they're going to be operating under, so meaning they could have anywhere from a 2-seat majority to maybe up to a 7- or 8-seat majority, depending on some of how these competitive races shake out in the next several days. But definitely a disappointing night for Republicans vis-à-vis what their expectations were going in.

And then on the Senate side, what we know for certain is that, in the sort of most competitive race bucket, Republicans lost Pennsylvania. So that means they're down one seat. They were able to hold onto Wisconsin, Florida, North Carolina, Ohio, which were all in the lean Republican column. And then among the real toss-up

seats, right now, in terms of where they're playing offense, the Arizona still has a tremendous amount of outstanding ballots to be counted. In Georgia, right, we know for certain that it's headed to a runoff. Neither Herschel Walker or Raphael Warnock were able to close 50% of the vote. Very close finish there. Warnock slightly ahead of Walker. So that's going to December 6th. And then Nevada is also very close. At this taping, there's estimates that there could be up to 100,000 mail ballots that still have to be counted and some day-of ballots for that matter as well. So that margin is obviously going to change between now and final counting. So that race is an open question mark in terms of how it shakes out.

So the easy way to digest this is that, for Republicans to salvage the Senate and to win control, they would have to win both Nevada and Georgia on December 6th. For Democrats, right, they just need to win one of those two, and they either maintain a 50/50 majority. Or if they're able to win both, they'll actually gain a seat and have 51/49 majority.

Allison Nathan: So it sounds like the biggest surprise coming out of this is, as you said, the Republicans'

disappointment in terms of the House in particular. That once again brings up questions about exit polls and their accuracy. What are your key takeaways?

Joe Wall: Yeah, I mean, if we look, like, the most competitive Senate races, so we saw, at least so far, the polls in Arizona look like they're off by about 6 points. New Hampshire off by 8.5. In Colorado, off by north of 6 points. Florida was off by almost 8 points. The other races were within the margin of error, but obviously some big misses there.

The House races are always a little bit more difficult because there's very little public polling. Obviously the campaigns are doing their own polling, super PACs, campaign committees, etc. But there's not a lot of transparency into the data.

I think one of the biggest surprises from the exit polling -- and this speaks to the House outcome -- is that, if you look at voters that say that they somewhat disapprove of President Biden, which is 10% of the electorate, they actually ended up voting for Democrats down ballot by a margin of 4 points. Usually, if you look at that sub sample

of voters who say they somewhat disapprove of a sitting president -- so if you look at Trump, for instance, in 2018, those who said they somewhat disapproved of Trump voted Democrat by a margin of 29, right? They swung the other way really hard.

In 2010, big wave year for Republicans. Those who said they somewhat disapprove of President Obama voted for Republicans by a margin of 40. This sort of broke historical norms in that voters who were not thrilled with President Biden, thrilled with the state of the economy, thrilled with the overall direction of the country didn't take it out on Democrats down ballot at the levels obviously they have in the past. So that I think speaks to the facts that, while the climate overall was bad and historical norms would say, gosh, if the political climate is such as it is now, the incumbent party is going to take on severe losses in the midterms. But at least this election cycle, and perhaps it speaks to obviously the polarization in the country, we're going to end up next year obviously the House is going to flip. The Senate we don't know quite yet, but it's safe to say we're basically going to have both chambers pretty close to 50/50. And that obviously is what it is today as well. And so I think we're slightly adjusting a little bit, but

it's basically a status quo outcome in terms of the division of the country.

Allison Nathan: Alec, talk to us about some of the policy implications for this. Let's start on the fiscal policy side, government spending. What do you expect?

Alec Phillips: There are two things that we know they're going to have to do. One is to just approve spending bills, keep the government open. And the question with that is usually not so much will they be able to do it, but what kind of other issues might get attached? And do those sorts of things end up threatening a government shutdown, as we've seen at a few points over the years? But I will say that, when you have what looks like it'll be a divided Congress with very thin margins in both chambers, it can make things difficult to do.

The bigger issue I think is going to be the debt limit. And so I think the question there is going to be do we have a repeat of 2011 or 2013, where you had these very disruptive debt limit experiences where, in 2011, the House ends up going to Republican control, the Senate ends up staying under Democrats. They're unable to get a clean

debt limit increase done, and negotiate a bunch of spending cuts to ride along with the debt limit. And finally get that done after a lot of disruption and, in fact, an S&P downgrade of the US sovereign rating. I think one big question right now is will we see all of that happen, you know, again in the sense of a big disruptive debate that ends with some kind of fiscal concession?

I think another scenario where it turns out more like 2013 and where Democrats decide or the White House decides that they're not going to negotiate on this, and ultimately that Republicans decide that there's not enough leverage there to really get something. So we don't really know which one of those it's going to be, but I think we do know that they're going to have to raise the debt limit. And that's probably going to be a focal point for any kind of fiscal policy decisions that have to be made next year.

Allison Nathan: And the big concern right now, of course, is that the economy tips into recession. How would a divided government respond to that?

Alec Phillips: Yeah, I think this is one place where, in theory, a divided government means not much

happens and the status quo continues. But in this case, a divided government could end up being a problem and actually sort of different from what one would typically expect.

If you look at the last few recessions, Congress has come in and passed a big fiscal package. Very big in the aftermath of the financial crisis and then in 2020 and 2021. But also pretty big even back after the 2001 recession. And so the question now is would a divided Congress be able to come in and do that? So I think what that probably means is that, number one, divided government just makes it less likely that they're able to get any kind of fiscal package or recession-fighting package done in a divided Congress. And then number two, that if they do it, it would probably be pretty small. And I'd imagine it would be smaller than what we've seen in the last three recessions. You're talking about maybe several tenths of a percent of GDP or maybe, at most, 1% of GDP, which would certainly be smaller than what we've seen in the past.

Allison Nathan: And perhaps more than in past midterm elections, geopolitics have been top of mind around China, around the Russian-Ukraine conflict. What changes, if

any, in foreign policy and national security are we likely to see?

Alec Phillips: So usually the answer following a midterm election is it doesn't really make any difference to foreign policy because that's the domain of the White House and the administration. I think in this case, it's a little bit different. And I would just point out two things.

One, on US-China, most of what we've seen recently has been coming from the administration, whether it's export controls or potential investment restrictions, other things along those lines. However, there is interest in Congress on a bipartisan basis in looking at further sort of restrictive policies related to China. And I think the one that is going to get a lot of attention in the near term is the Taiwan Policy Act, which actually could pass in a lame duck session before the end of this year. But if it doesn't, it I think would be very likely to come up next year.

And I don't know that the election result actually changes the outlook for that all that much, but I would just point out that, over the last couple of years with exceptions, I think Democratic leadership has tried to prevent any

inflammatory issues from coming up in Congress and getting presented to the president. And to the extent that there have been pieces of legislation that relate to foreign policy, I think they've tried to massage those so that they don't create as many diplomatic issues.

And I think the difference will be that, if Republicans are controlling the calendar and writing legislation that could make it to the president's desk or even just come up for a vote, they may be a little less inclined to make it easy for the Biden administration. That could produce more headlines. I don't know that it actually really changes the policy outcomes that much.

And then on Ukraine, in some ways, it's a simpler issue which is will Congress continue to provide funding for military support? And I think the answer is basically yes. Kevin McCarthy, the incoming speaker, or likely speaker, has raised doubts about whether Republicans would support military aid to Ukraine to the extent that they have and that Democrats have recently. But I think ultimately, the question is really just will they let military aid run out and essentially force Ukraine to go it alone without US military support? And that just seems very hard to

imagine. And so while there may be less enthusiasm around it and they might try to reduce the funding levels a little bit, ultimately, I have a hard time seeing how they actually change the fundamental status of the US as it relates to Ukraine funding.

Allison Nathan: Joe, we turn back to you. When we think about the midterms, always in our mind is what's going to happen in 2024, the next presidential election. So given this result of a divided Congress, very tight margins, what do you think will be the main implications for the upcoming presidential election?

Joe Wall: Of course, any conversation about the 2024 presidential race starts with whether or not the candidates from four years ago -- President Biden and former President Trump -- are going to run. Expectations in the media have been that President Trump is expected to announce his candidacy next week, November 15th. Given the results last night, some are questioning whether he'll follow through with that or not. Who knows?

I think on President Biden, the results from Tuesday night, I think at least give him a little bit more room to make a

decision. I think there was a view that, if it was a really tough night for Democrats down ballot, that the pressure would have sort of been mounting on him to make a decision. Whereas now, I think he probably gives himself a little bit more room, decision. My sense is he's not going to make a public declaration anytime soon.

So the Democrat obviously field remains unsettled until he makes an official call. And on the Republican side, I think the results from last night, just given that a lot of the down ballot candidates that Trump supported, particularly in Senate races, did not win and there's a lot of finger pointing in terms of his involvement in some of those races, in the aftermath, that, gosh, if they would have elected a more conventional candidate, they could have won some of these seats.

So as a result of that, I think, you know, Trump's standing for '24 is definitely weakened vis-à-vis where it was just a few days ago. And meanwhile, obviously Governor DeSantis in Florida was the star of the night in that he won Florida by almost 20 points across a variety of demographic groups. He won eye-shocking numbers. He won Miami-Dade County with 50 -- 55% of the vote. He had lost

Miami-Dade by 20 points just four years ago. He's the only Republican gubernatorial candidate to win Miami-Dade, dating back to 2002 when Jeb Bush won. So he could not have had a better night.

So DeSantis is at a rock star level. Trump obviously did not probably get the results he was hoping for. So I think that just means that there's going to be more appetite to challenge Trump if he does in fact run not only from the likes of Ron DeSantis, governor of Florida, but also a host of other candidates that I think are probably going to give it a more serious look than they may have would if Trump had a better night in terms of the Republicans having a big wave and he could have taken some of the credit for that. Now it's a little bit of a different picture.

Allison Nathan: What about the implications for Congress? Is it too early to discern a path for the parties when it comes to the House and Senate in 2024, given the outcome of this midterm?

Joe Wall: So we know for certain that the Senate map in 2024 in a lot of ways cannot be any better for Republicans. You have eight Democratic senators up for

reelection that come from sort of vulnerable seats in states that are obviously very close. So you have Senator Joe Manchin coming from the most red state, West Virginia. He's up for reelection. Senator Tester from Montana, a state that Republicans have been convincingly winning the last few cycles, he's up. Senator Sherrod Brown from Ohio, who's been able to navigate the politics of Ohio as well as just about any Democrat possibly could. But Ohio only grew more red, particularly at the gubernatorial level on Tuesday night. So I think those three are in the most vulnerable category.

And then you have five other Democratic senators coming from states that Biden won by less than 3 points. So Senator Sinema from Arizona, Senator Rosen from Nevada, Senator Baldwin from Wisconsin, Senator Stabenow from Michigan, and Senator Casey from Pennsylvania, all up for reelection. And so those eight are going to be on the list off the top that are going to face challenging races. And of course primaries matter, as we learned last night. But those just on paper are obviously going to face difficult reelections.

And on the Republican side, the only one on paper you

would say is vulnerable, just given the results from his last reelection, would be Senator Rick Scott from Florida. But after last night, the fact that Rubio won easily and obviously we just spoke about Governor DeSantis's convincing victory, it's tough to say that Senator Scott is in serious threat. So that's just to say that Republicans should only gain seats, and it's hard to imagine them losing seats in the Senate in two years. So it's an advantageous map for them.

And then in the House, I think given how tight the margins look like they're going to be, the House is very much up for grabs in 2024. Usually, if you just look back at the last 20 years in a presidential cycle, you don't tend to see a lot of movement in the House. We did see sort of obscure dynamic in 2020 where Biden of course won, and Democrats meanwhile, the House lost 13 seats. But usually the President's party, on average, gains a few seats if you're in the winning president's party. But given how close the margins are, I think the House is up for grabs. So the Republicans probably feel better about, on paper, their prospects of winning the Senate than maintaining the House perhaps.

Allison Nathan: And you mentioned the importance of demographic shifts in the Florida governor race. What does the exit polling show more broadly about demographic changes in the Republican coalition and in the Democratic coalition?

Joe Wall: Yeah, so I think one of the semi surprises from last night was just the margins. If you dive into the age brackets, a lot of the old voters definitely voted clearly more on the economy. And they were much more impacted in terms of how they thought about their vote when it comes to inflation and the economy versus social issues.

If you look at just the national data, Republicans won voters 45 to 64 by 10. They won voters 65 and over by 12. But Democrats, where they did incredibly well is amount 18 to 29 year olds. They won by a margin of 28. And in among 30 to 44 year olds, they won by a margin of 4.

If you look at Pennsylvania, which is really, you know, we always said throughout the fall, if you want to watch one seat, Pennsylvania is probably going to determine control of the Senate. And among 18 to 29 year olds, John

Fetterman, the winning candidate of course for Senate, won by 23 points. If you go back to 2016, Trump vs. Clinton, Secretary Clinton only won 18 to 29 year olds by 9. So that just speaks to the intensity level with younger voters who I think were very motivated when it comes to particularly the abortion issue. And I think that was definitely undervalued in polling.

Perception had been over the last couple of months that abortion was obviously front and center over the summer when the Dobbs decision came out. And then beginning in the latter part of September, the polls started to shift towards more of a focus on economic issues. But I think those polls clearly missed that a lot of voters were still very motivated by Dobbs decision.

Allison Nathan: Alec, I'm staring at my screen right now, and there is a big selloff in equities underway post these results, following what was a couple of strong up days in the markets in anticipation of Republican gains. Stocks usually rise in the year after midterm elections, so do you think that will happen again this year?

Alec Phillips: I think you have to say it's sort of a

strange trend in US equity markets. And it actually even to some extent carries across to international equity markets where, if you look at the 4-year US political cycle, starting with the inaugural year and then the second year, the midterm year, and then the presidential election year, which is that, in almost every case going back several decades, US equities and the S&P in particular have risen and have had positive returns in the third year of the cycle.

And it's an oddly consistent pattern. And I'll say I've gone back and tried to figure out and spend a decent amount of time trying to figure out why that would be and what it is fundamentally that's changing from a policy perspective or economic perspective. And it's kind of hard to identify the actual government policy change would be that's driving that. And yet it does keep happening.

I think what you can say is that volatility rises going into the midterm versus other years. Seasonally around the election in midterm years is just a higher volatility period. And then it falls again after the midterm. So maybe political uncertainty plays some kind of a role. But generally, I think the question is all of that, as important as some of the other issues that markets are thinking about,

whether it's Fed policy, whether it's recession risk, whether it's the impact of inflation on earnings and so on. And I would think it's probably not. And so it leaves me a view that ultimately this is such a strong trend, and it's hard to explain and yet it keeps happening that I wouldn't be surprised if it happens again next year.

But for what it's worth, our equity strategists do think that we're going to have a soft market through the end of the year. And their target for the S&P year end this year is 3,600, which would be a little bit counter to that trend where typically you see a rally through the end of the year after Election Day. But it would then be consistent with the idea that the third year is strong, and they basically show then a 4,000 S&P target for the end of 2023, so that would be upside from the current level.

Allison Nathan: And are there any particular sectors that are expected to outperform or underperform with this new Congress in place?

Alec Phillips: I think the first general point would be that, now that we've seen the results and that the results are -- even though the Senate turned out differently

and the margins are different -- directionally, we do have divided government, which is what was expected. So given all of that, I would say it would be surprising for markets to start to price in something that was already expected. So I don't think that there's really going to be a big shift from here on in market views about the individual sectors and how they fare under a new Congress.

With that said, I think in general Republican control is thought to be better for areas of health care. So biopharma, health insurance, parts of the financial sector from a regulatory standpoint, parts of the energy sector. When you consider all of that, the divided Congress is probably beneficial for some sectors and probably for equities as a whole because of the tax piece. It's just that I think most of that has already been priced for a while.

And then the only other thing I'll mention on all of that is that there had been some question as to whether Republicans, if they took control, particularly with big margins, of the House and Senate, whether they would be able to roll back some of what Congress enacted earlier this year on renewable energy and all of the subsidies there. And I think one sort of benefit of a divided Congress is that

it is less likely that you'll see a rollback of those. And so that would be probably a better scenario for renewables than what you would have had if it was a fully Republican Congress.

Allison Nathan: Finally, you've both covered countless election cycles. How meaningful are these results or this election in general relative to past elections?

Alec Phillips: So I'll say, from a market standpoint, it does not rank highly among midterm elections or US elections generally in terms of investor interest. And I would say my impression is it's probably for two reasons. One is because of some of the things we just talked about. The fact that Fed policy is so much in focus right now. The fact that there are economic concerns that probably outweigh political concerns. The fact that, because the Fed is in a hiking cycle to the extent that you've got any kind of big fiscal change, it might just be offset with countervailing moves from the Fed that would neutralize the economic impact. So I think for those reasons, it's probably a little less important than previous elections have been.

The other thing I'll just point out is that I think there was a lot of skepticism that Democrats would really do all that much, even if they did maintain control, based on the fact that they were unable to do very much this year, particularly around the big reconciliation package, the big fiscal package, which started out as, like, a \$4 trillion package and ended up being well under a trillion dollars and was a struggle to get done. And so I think, given all that, there just wasn't seen to be as much of a difference between a Republican Congress and a Democratic Congress because nobody was really expecting either one to do all that much.

Allison Nathan: Joe, do you have any thoughts?

Joe Wall: I agree with everything Alec said. I do think, in terms of, like, surprising outcomes -- and it's a midterm so it's not going to get nearly as much attention as a presidential outcome obviously. But last night's results I do think stack up as one of the most shocking miscalls of the same ilk as a 2016 just in terms of how off projections and for that matter some of the polling data was.

We say this after every cycle, right? The polling obviously

is a significant problem. There was a school of thought that, with Trump not on the ballot, the polling is better and more accurate, but obviously that's not the case, at least in a lot of the states and in a lot of the districts. So a lot of soul searching on the data front, but I think there's a lesson to be learned, right? We all end up drifting back to the polls because it's all we have. And the reality is, despite how many times they've missed and have been off, we still give them a lot of credence. Another lesson to be learned.

Allison Nathan: Alec, Joe, thank you for sharing your time and insights during a very busy week.

Joe Wall: Thank you.

Alec Phillips: Thanks.

Allison Nathan: Thanks for joining us for this special episode of Exchanges at Goldman Sachs, which was recorded on Wednesday, November 9th, 2022. If you enjoyed this show, we hope you follow on your platform of choice and tune in next week for another episode. Make sure to share and leave a comment on Apple Podcasts,

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