Investment Insights

Midterm Elections — Markets, Policy, and Implications

Bree Sterne
Investment Strategist

Madeline Simone
Investment Strategies Analyst

Highlights

- An economic backdrop of slowing growth and high inflation has contributed to President Biden's low approval rating ahead of the midterm elections.
- With Republicans likely to capture at least the House of Representatives, some form of divided government is the most likely outcome, in our view.
- A split government generally provides a positive backdrop for risk assets with a more stable policy outlook likely to help comfort markets after a volatile year.

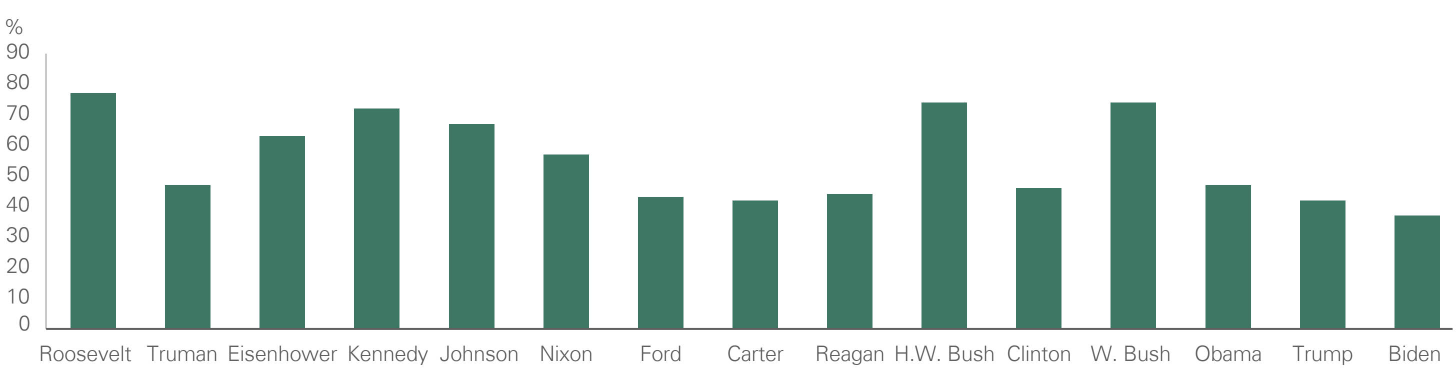
Following a burst of legislative activity this summer, we expect the focus in Washington to quickly turn toward the 2022 midterm elections when lawmakers return from their August recess. While politics are rarely a key driver of markets, policy changes can have notable implications for sectors, and the removal of policy uncertainty can also provide a tailwind for markets. Therefore, it is important to understand the political environment considering the upcoming midterm elections.

Political Backdrop Entering Midterms

The combination of a slowing economy and high inflation has created a challenging political environment ahead of the midterm elections slated to take place on November 8, 2022. Recession fears are elevated, and consumers are feeling the effects of the highest inflation in 40 years. Recent polling indicates that nearly 71% of voters think that the country is currently headed in the wrong direction. Over the summer, President Biden's approval rating of 37% reached the lowest level of any modern president 18 months into his presidency, falling below President Trump at the same point (Exhibit 1).

Exhibit 1: Historical Presidential Job Approval After 18 Months

Key Takeaway: Biden has the lowest job approval of any modern president.



As of July 6, 2022.
Source: G. Elliot Morris, The Economist

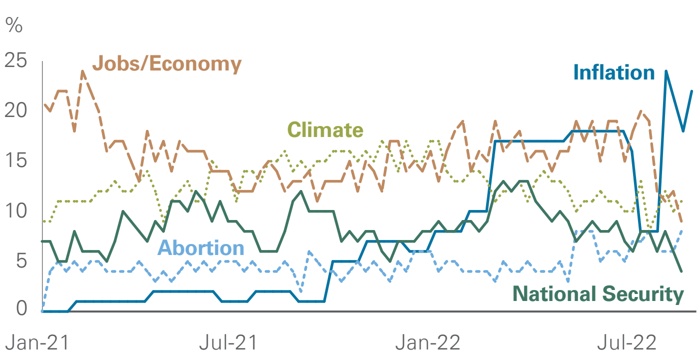
President Biden has seen his support weaken among suburban voters as well as independents, two groups that were pivotal in voting former President Trump out of office. Biden has even seen erosion among the Democratic base with his approval rating among the group dipping to a low of 70% this summer, though some polls indicate a slight uptick since. Base support for candidates is typically around 80%.

High inflation has been a key factor behind the current political discontent and low presidential approval ratings. In a recent poll of the most important issues facing U.S. voters, inflation was named the number one deciding issue ahead of the midterm elections (Exhibit 2). Consumer sentiment readings reflect how the highest inflation in decades is affecting the cost of living and souring the mood of Americans across the country. Historical data confirms the inverse relationship between inflation and political satisfaction, which can especially be seen in the correlation between gas prices and presidential approval (Exhibit 3).

As inflation expectations have declined and gas prices have fallen from their summer highs, President Biden has seen a modest improvement in his approval rating. Special elections often provide some insight into national sentiment, and recent August elections revealed political momentum turning in favor of the Democrats. It is likely that the Supreme Court ruling on abortion alongside the passage of several pieces of legislation in the final weeks of the summer has helped to boost Democrats' interest in the midterm elections. Please see the sidebar on page 4 for our key takeaways on the recent legislation.

Exhibit 2: Most Important Issues Facing U.S. Voters

Key Takeaway: Inflation is the top issue for voters in the midterm elections.

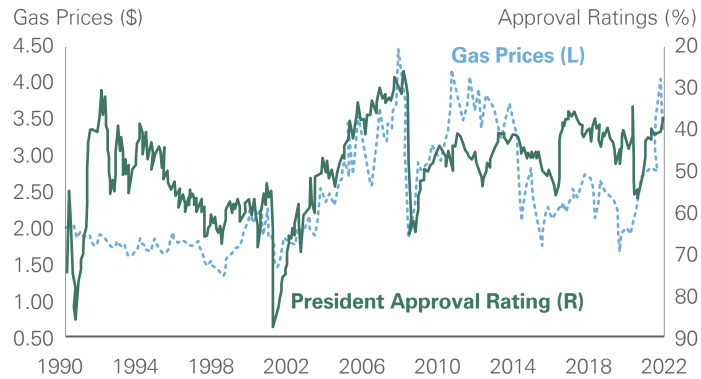


As of August 9, 2022.

Source: YouGov Poll of U.S. Voters

Exhibit 3: Gas Prices and Presidential Approval Ratings

Key Takeaway: Presidential approval ratings have a high correlation with gas prices.



As of August 22, 2022. Right-hand side inverted. 4-week rolling average of weekly real gas prices.

Source: Strategas

Incumbent Party Losses in Midterm Elections

Heading into the 2022 midterms, Democrats control the House of Representatives while the Senate remains split with Vice President Harris able to cast the tie-breaking vote in favor of the Democrats. Given the current economic backdrop and historical midterm trends, our base case is for the Republicans to take the House while the Senate remains a toss-up, in our view.

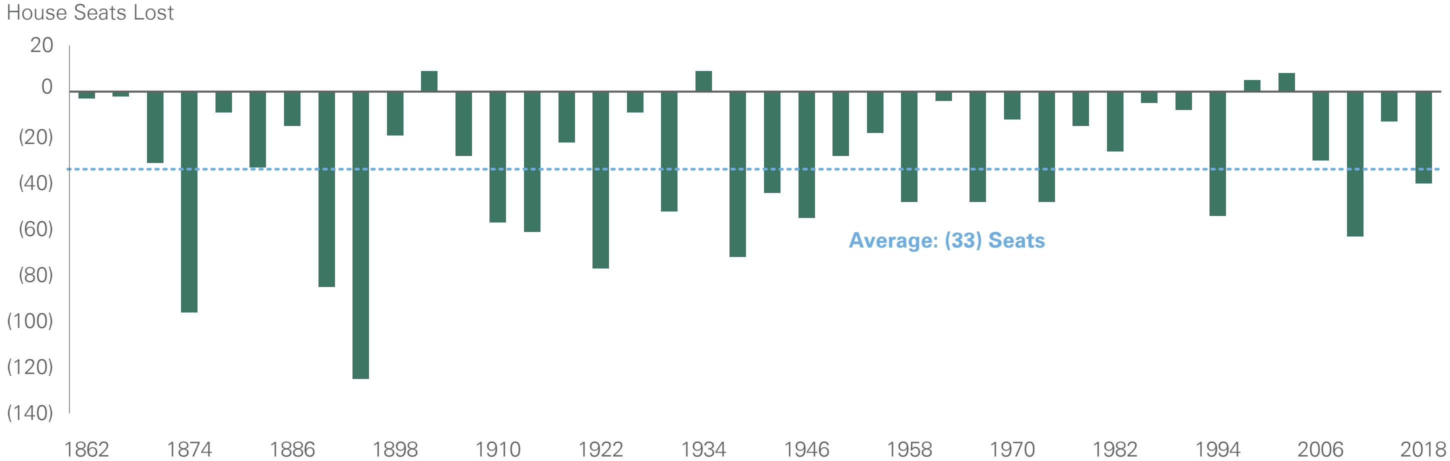
The House of Representatives

Midterms have a strong historical tendency to favor the party not currently in the White House, particularly in the first term of a presidency. On average, the party of the incumbent president has lost 33 seats in the House of Representatives in midterm elections (Exhibit 4). In the last 150 years, there have been only four instances where an incumbent president has seen his party gain seats in the midterms, and usually this occurred amid special circumstances. For example, the Republicans did well under President Bush in the wake of 9/11, and the Democrats gained power under President Roosevelt in 1934 given the popularity of the New Deal.

There is a historical correlation between seats lost in the House of Representatives during midterm elections and presidential approval rating. Presidents, on average,

Exhibit 4: Number of House Seats Won or Lost by Incumbent President's Party in Midterm Elections

Key Takeaway: An incumbent president's party tends to lose seats in midterm elections.



As of 2018.

Source: Brookings Institute

lose about seven percentage points on their approval ratings between inauguration and the midterms. With President Biden's approval rating declining from 55% to around 40% during his time in office, it seems likely the Democrats will face losses in the House.

The current House makeup is 211 Republicans, 220 Democrats, and four vacancies. This is the narrowest margin of Democratic control since the 1940s (Republicans held the House by a narrower margin 20 years ago). The Republicans only need seven seats to flip the House.

Polls are suggesting Republicans have a strong edge in the House of Representatives. Race to the White House data is giving Republicans a 66% chance of winning the House while FiveThirtyEight gives Republicans a 77% chance of taking the House.

In addition to an inflationary backdrop and midterm trends against incumbents, Republicans are also likely to benefit in the House due to the electoral map and retirements. Of the 34 races that RealClearPolitics rates as a toss-up, 29 are held by Democrats. Democrats are also poised to see the largest number of retirements in 30 years. In the House, 22 Democrats are retiring compared to 10 Republicans.

The party with the greatest number of retirements is at a relative disadvantage as an incumbent running is more likely to retain his party's seat while open seats are more likely to switch parties.

While the consensus is that Republicans will win the House, the question remains whether it will be a red ripple, wave, or swell. Polls currently indicate Republicans will win around 10 to 20 seats, but it is possible that they win 25 seats or more. Based on historical correlations, inflation adjusted gasoline prices of $4.00 are consistent with a roughly 35- to 40-seat loss (Exhibit 5).

Key races that we are watching to gain insight into the extent of a likely Republican win are Arizona, California, Illinois, Maine, Michigan, Nebraska, Nevada, New York, Ohio, Pennsylvania, Texas, and Virginia. In particular, the races in Virginia and Michigan are likely to be in focus and could prove to be indicators of national sentiment. Democratic candidate Abigail Spanberger is seeking reelection in Virginia, a state that Biden won by a narrow margin but that has since elected a Republican governor. Meanwhile, Michigan has a 1931 law banning abortion that could come back into effect since Roe v. Wade has been overturned.

Exhibit 5: Real Gasoline Prices and Lost/Gained House Seats for Incumbent President's Party (1978–2018 With 2022 Forecast)

Key Takeaway: Higher gasoline prices correlate with larger House losses for the incumbent party.

As of 2018 with 2022 forecast. Real gasoline prices are calculated by dividing the nominal price by the ratio of the CPI in that month to the EIA forecasted August 2022 CPI.

Source: Strategas, EIA

The Senate

The Senate is likely to be more in focus this year given the uncertainty regarding a Republican or Democratic outcome. Betting odds on which party will control the Senate after the 2022 election recently flipped from Republicans taking control to Democrats holding the Senate. Predictit, one such political betting market, saw a 75% chance of Republicans retaking the Senate in June; however, this has since flipped, with betting odds now giving the Democrats a 63% chance to win the Senate.

While general midterm election trends favor Republicans as discussed above, the Senate tends to be more idiosyncratic than the House given its longer term length. Because of the Senate's six-year term, the specific seats that are up for reelection were influenced by political dynamics six years ago and before the prior presidential election. The president's party has historically averaged a loss of three Senate seats in the midterm election, though it is not uncommon for the president's party to sometimes see small gains.

Recent Legislative Activity

CHIPS and Science Act of 2022

The recent passing of the CHIPS and Science Act provides $52 billion in funding to the semiconductor industry, with funding subsidizing domestic manufacturing, R&D programs, and defense-oriented semiconductors. It also includes a 25% investment tax credit for capital expenses for the manufacturing of semiconductors and related equipment to incentivize domestic manufacturing. The U.S. share of commercial semiconductor manufacturing has declined from 37% in 1990 to 12% today due to significant incentives offered by global competitors. As a result, the cost of constructing and operating a semiconductor manufacturing facility is 25% to 50% higher in the U.S. This act is a positive for semiconductors and companies poised to benefit from the returning, or "reshoring," of manufacturing to strengthen domestic production and supply chains.

Inflation Reduction Act of 2022

The Inflation Reduction Act raises $772 billion in revenue and has $433 billion in spending, for a deficit savings of $339 billion. The key tax provisions of this include 15% book minimum income tax on companies with revenue more than $1 billion or foreign companies with U.S. earnings more than $100 million, a 1% excise tax on buybacks more than $1 million for public companies, and IRS funding for enforcement. The bill includes drug price control on prescription drugs and limits drug price growth to inflation. Spending in the bill includes an extension of existing health insurance subsidies through 2025 and more than $370 billion toward clean energy incentives for individuals, funding for clean energy manufacturing, and tax credits that target investments in reducing emissions in every sector of the economy. The law is estimated to reduce the federal deficit by about $300 billion over the next 10 years.

The Inflation Reduction Act is likely to impact earnings with many corporations paying at least a 15% tax but to a smaller degree than the bill initially proposed given various loopholes. The inclusion of depreciation for the book minimum income tax shifted the impact from manufacturing companies toward utilities and financials. Drug pricing controls could hurt innovation and profits within the healthcare industry, but the immediate impacts are mitigated as only 10 drugs are affected starting in 2026. The energy provisions are a major positive across the clean energy space, benefiting wind and solar companies, electric vehicle companies, and companies that are transitioning toward renewable energy.

Furthermore, nuanced Senate election dynamics create a more mixed picture for Republicans. There are 35 Senate seats up for election; 21 of those are held by Republicans, and 14 are held by Democrats. Therefore, Republicans face an additional challenge in taking the Senate as they are defending an additional seven seats relative to Democrats. Democrats also have a more favorable Senate map with closely contested seats in states that Biden largely won in 2020.

In the Senate, seven states will likely determine who controls the chamber: Arizona, Georgia, New Hampshire, Nevada, North Carolina, Pennsylvania, and Wisconsin (Exhibit 6). With Republican retirements in North Carolina and Pennsylvania, Democrats have an opportunity to be more offensive. Georgia was the most closely divided state in the 2020 presidential election, making this a key state to watch for voter turnout and to see how voters are leaning this year. Republicans were initially favored to win in Georgia, but the odds of winning have now switched to the Democrats. Pennsylvania is projected to be a very competitive race, as Pennsylvania elected Trump in 2016 and Biden in 2020.

Midterm Election Scenarios

Most public sentiment data we see confirms a competitive race in November for Senate control, with Republicans' retake of the House gavel very likely. We believe a divided government with a Democratic president and either a Republican House and Senate or a Republican House and Democratic Senate are the most likely outcomes. A Democratic House and Senate is the least likely scenario, in our view. Please reference Exhibit 7 for a summary of the scenarios we discuss on the next page.

Exhibit 6: Key Senate Races to Watch in 2022

State	Incumbent	Reasons to Watch
Arizona	Mark Kelly	• Democratic campaign has fundraised much more than the Republican campaign • Kelly won by a small margin in a special election • Close state in the 2020 election • Current governor is Republican
Georgia	Raphael Warnock	• Warnock had a narrow win in a special election • Closest state in the 2020 election • Opponent Herschel Walker is endorsed by Trump
New Hampshire	Maggie Hassan	• State has recently voted for Democrats in presidential elections but has a Republican governor
Nevada	Catherine Cortez-Mastro	• Cortez-Mastro is a first-term incumbent • Opponent is a Trump-endorsed former state attorney general
North Carolina	Richard Burr (retiring)	• Incumbent Burr is retiring • Polling is showing a very close race
Pennsylvania	Pat Toomey (retiring)	• Incumbent Toomey is retiring • Close state in 2020 election • Polling is leaning toward the Democrats • Republican primary was crowded and competitive
Wisconsin	Ron Johnson	• Close state in 2020 election • Biden won the state in 2020, but Republicans hold the Senate seat

Blue or red icon signifies the political party of the current Senate seat.

Source: Bessemer Trust

Scenario 1: Republican House and Democratic Senate

If Republicans capture the House but Democrats retain the Senate, we are likely to see a more divided government at the federal level with increased levels of gridlock. In this scenario, there would be a change of committee leadership in the House, and a Republican speaker would set the agenda. Thus, losing the House would neutralize the Senate because both chambers are needed to pass a bill. Major policy shifts are unlikely as neither party would be able to pass sweeping legislation with a Republican speaker of the House controlling the agenda and a Democratic president holding veto power. Divided-government agendas are generally minimalist and focused on fiscal policy, oversight, and nominations. Still, there are several bipartisan areas of focus where activity may continue regardless of the outcome — key ones being national defense and cybersecurity amid heightened geopolitical risk.

Scenario 2: Republican House and Republican Senate

If the Republicans capture both the House and the Senate, much of what we expect under a divided Congress would be unchanged — notably gridlock, minimal policy progress, and a focus on laying the groundwork for 2024. Practically speaking, if the House is controlled by Republicans and the presidency by the Democrats, the Senate outcome is not as critical for policy. Still, a Republican Senate would have other political implications since the Senate is responsible for approving various appointments, including cabinet members, ambassadors, Supreme Court judges, and the Federal Reserve Board of Governors. Therefore, it would likely be much harder for Biden to receive approval for key nominees in a Republican-controlled Senate.

Even though it is highly unlikely that any major changes would be signed into law, Republicans would have increased influence over setting policy priorities ahead of the 2024 presidential election. With Republicans in control of both chambers, there would likely be increased pressure for export controls, a focus on energy security and domestic drug manufacturing, and a lower likelihood of antitrust legislation.

Scenario 3: Democratic House and Democratic Senate

In the unlikely scenario that Democrats are able to maintain control of both chambers, we could see a reacceleration in the Biden agenda, including a focus on higher taxes on corporations and the wealthy in order to fund investments in clean energy and adjust social policies. In this scenario, we would be on the lookout for tax reform proposed earlier by the Biden administration, including changes to the estate tax exemptions, capital gains tax rates and step-up provisions, and the corporate tax rate. Furthermore, Democratic control of both the House and Senate would likely mean limited extensions of the TCJA provisions. Recall the phaseouts have already begun this year for corporations, and the individual tax reform provisions are scheduled to expire at the end of 2025. However, the probability that the Democrats maintain control of both the House and the Senate is fairly low with the prediction market currently giving this outcome a 25% chance.

Exhibit 7: Midterm Election Scenarios for the House and Senate

Republicans Win Both House and Senate	Republicans Win House and Democrats Hold the Senate	Democrats Retain Both House and Senate
Potential Policy Outcomes	**Potential Policy Outcomes**	**Potential Policy Outcomes**
• No new taxes	• No new taxes	• Democrats push forward remaining Build Back Better agenda items
• Focus on domestic energy security	• Debt-ceiling fight	• Climate change initiatives
• Headwinds for the Biden agenda	• Minimal new spending	• Focus on antitrust
• Minimal new spending	• Potential judicial appointments approved	• No debt-ceiling fight
• Debt-ceiling fight	• Increased defense spending	• Increased defense spending
• Increased defense spending	• More stringent China oversight	• Additional drug price controls
• More stringent China oversight	• Less pressure on big technology companies	• Tax increases on wealthy individuals and corporations
• Limited scrutiny of big technology companies		• Increased government spending
• Investment in domestic manufacturing		

Source: Bessemer Trust

Market Implications of Election Outcomes

It is important to remember that there are many more important drivers of markets than elections, including the underlying economy, company earnings, and valuations. Still, elections can have important implications for policy that can affect certain industries and sectors. Additionally, in a divided-government scenario, a less volatile policy outlook might comfort markets after a year that has seen macro factors destabilize markets.

Overall, a divided government tends to be a positive backdrop for risk assets as it decreases the likelihood of sweeping legislation that could have negative ramifications for markets. Thus, a split Congress is likely to provide a check on less market-friendly elements of the Biden agenda. For example, if Republicans win at least the House of Representatives, which we believe is probable, there is a very low likelihood that new tax increases would be passed.

Furthermore, having the midterm elections in the rearview mirror may allow investors a sigh of relief that one element of market uncertainty has passed. Indeed, looking at prior midterm elections, that has been the case historically. The S&P 500 has not declined in the year after midterm elections since 1946; average 12-month returns following midterm elections are 15%, versus 7% for all other years. In addition to equity markets, political developments can impact municipal bond issuance as well. The municipal bond market has historically experienced a material increase in issuance in the month preceding significant elections or policy roll-outs as issuers and underwriters look to place their deals ahead of any potential volatility. Recent notable examples of this dynamic include October 2016, December 2017, and October 2020.

What to Watch Ahead of the Midterms

In the weeks leading up to the midterm elections, we will be closely watching several factors that are likely to influence the outcome (Exhibit 8). The first of these are the economic environment and trajectory of inflation, especially energy prices given the clear correlation between gasoline prices and both presidential approval ratings and the number of House seats lost during midterm elections. The direction of commodity prices, as well as economic data such as the CPI and employment reports, will help investors and voters get a pulse on the state of the economy in the lead-up to the election. Beyond the overall presidential approval rating, we will also keep an eye on key voting group intentions given the importance of voting patterns for several cohorts, including suburban women, independents, and Latina voters.

Finally, eyes across Washington and Wall Street will be closely watching the Trump factor. While midterm elections are typically a referendum on the sitting president, should the former president decide to announce his intention to run in 2024, this dynamic could be altered. If Trump enters the presidential race early, the midterm elections could become more like a presidential race but for control of Congress rather than a referendum on the sitting president.

The Bessemer team will be keeping a close eye on the evolution of the policy and market dynamics in the lead-up to the midterm elections and will be communicating with additional updates in the coming weeks and months.

Exhibit 8: Election Timeline — What to Watch

September			October		November
Sept. 2 August Jobs Report **Sept. 6** Senate Returns From Recess **Sept. 13** August Inflation (CPI) Data House Returns From Recess	**Sept. 21** FOMC Meeting **Sept. 13-27** UN General Assembly **Late-Sept./ Early-Oct.** Early voting in IL, ME, MI, MN, MT, NB, SD, VT, VA, WY	**Sept. 30** Reconciliation Vehicle Expires	**Oct. 7** September Employment Report **Oct. 13** COVID-19 Public Health Emergency Expiration September Inflation (CPI) Data	**Late-Oct.** Early voting in AL, AK, CO, DE, DC, GA, FL, HW, ID, LA, MD, MA, ND, NJ, NY, TX, UT, WV, WI	**Nov. 2** FOMC Meeting **Nov. 4** October Employment Report **Nov. 8** Midterm Election

Source: Bessemer Trust

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