MAGA, MID-TERMS AND MARKETS

PERPETUAL INVESTMENTS
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The sound and fury of the mid-term elections in the US have come and gone, yet little seems to have changed. Overall the result was in line with expectations. Democrats took control of the House of Representatives whilst Trump's Republican Party strengthened its hold on the US Senate.

What did it say about Trump, his policies and his promise to Make America Great Again (MAGA)? Not that much. In general, like by-elections, mid-terms are an opportunity for voters to vent and protest without changing the Presidency itself. So, the incumbent party tends to lose. Republicans lost the support of many white, college educated suburban voters (think of seats like Wentworth, recently vacated by Malcolm Turnbull) which cost them control of the House. However, rural voters turned out in greater numbers which helped counterbalance these losses in state-wide Senate races. Interestingly, the vote for the Senate race in Florida, which the Republicans appear likely to win by a narrow margin, is reminiscent of what happened there in the 2016 Presidential election year.

"Gridlock is good"

Split decisions like this, where different parties control each chamber of congress, are generally good for markets. In fact, over the last 60 years the US equity market has delivered its best returns when control of the Congress is split between the parties. Interpret this which way you will. Either nothing gets done (and businesses generally like the certainty of no new laws getting passed) or at least whatever gets done needs broad political agreement and won't be revolutionary.

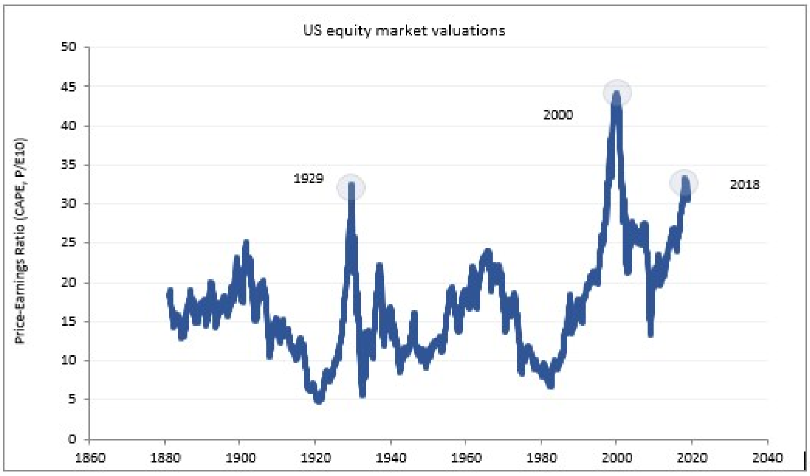
The risk of impeachment also hangs in the air. But the reality is that impeachment is probably not what most people think it is, and it is as much about political theatrics as the rule of law. The two Presidents who have actually been impeached (Andrew Johnston and Bill Clinton) were never removed from office and served out their full terms. What most people get wrong is the fact that whilst the House can impeach a President all this means is that they go to trial in the Senate where a significant two thirds of the Senate are needed to convict the President and remove them from office. Since the Senate is controlled by the Republicans this seems highly unlikely unless irrefutable evidence of crimes emerge and / or the President's support collapses (amongst the rank and file and / or the Republican senators).

Markets move on - and the Fed holds the key

In any event, what happens at the White House or in the gridlocked United States Capitol Building is probably less important than what happens at the other end of Constitution Avenue in Washington DC - at the headquarters of the US Federal Reserve. Whilst Presidents and Congressmen and women have come and gone over the past ten years the Federal Reserve has consistently pulled powerful policy levers. In the years since the Global Financial Crisis interest rates were slashed and the balance sheet of the US Federal Reserve grew from $1 trillion to over $4.5 trillion - the most extraordinary deployment of expansionary monetary policy in the century that the Fed has governed the monetary system. Since the end of 2015 they have been gradually applying the brakes by slowly but persistently raising interest rates and draining nearly half a trillion dollars from the financial system.

Bond valuations have moved largely in lockstep with the Fed and equity valuations have followed behind. The Fed is fast approaching a critical juncture as we move into 2019. As unemployment reaches 49 year lows, inflation creeps above their 2% goal, wage rises hit 3.1% per annum and they ditch "accommodative" references from their statements, at what point will the US Fed reach its "neutral" policy rate (currently considered to be about 2.5%) and tighten policy to head off overheating in the economy? How do bond markets respond to this stance? The 10 year note has recently touched a yield of 3.25%. How, in turn, do equities respond, with widespread forecasts that equities begin to struggle as the 10 year note reaches 3.25-3.5%? With US equity valuations - whether measured by price to earnings ratio or as a percentage of GDP - already having risen to levels witnessed only a handful of times in history, the next few decisions by the Fed will dominate the outlook for business and investors far more than the mid-terms could ever do.

US Equity market valuations



Source: Robert Shiller, Yale

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