ElectionWatch

4 September 2018
Chief Investment Office GWM
Investment Research

Examining the 2018 congressional races

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Do midterms matter?

UBS

Do midterms matter?

Markets and the economy have—for the most part—thrived over the past two years under a unified Republican government. Bolstered in part by fiscal stimulus that coupled a sweeping tax reform package with higher government spending, as well as broad-based regulatory relief, the economic expansion that started nearly ten years ago under President Obama has persisted—and even accelerated—under the Trump administration. The unemployment rate is scraping record-low levels, inflation has picked up but remains contained, and the US stock market has been pushed to all-time highs amidst record earnings.

Mike Ryan, CFA
Chief Investment Officer Americas, Global Wealth Management

Justin Waring
Investment Strategist Americas, CIO Global Wealth Management

Naturally, the economy is driven by many more important factors than US politics, and we should bear this in mind as we consider the possible impact of the 2018 congressional midterm elections. After all, there's no noticeable correlation between the party in power and the performance of markets.

In addition, market reaction to policy changes is often different than expected. For example, during the 2016 election many analysts (ourselves included) were broadly accurate on the likely policies of the Trump administration but focused too heavily on potentially market-negative aspects of the campaign's proposals—such as trade tariffs—that haven't yet had a significantly negative market impact.

Research has shown that political bias can significantly hamper investors' ability to make prudent investment decisions—especially if they allow political disappointment to morph into investment pessimism or fear. As a result, we recommend against making any major investment decisions based on political forecasts or beliefs alone.

Even so, we do need to assess how the election could affect policymaking, economic fundamentals, and financial markets.

As with most midterm elections, the scope for policy changes is more limited than during presidential elections. Notwithstanding the heated rhetoric on both sides and obsessive media focus, the US system still provides a great deal of power to the executive branch of government regardless of the makeup of Congress.

A more confrontational Congress may limit President Trump in some areas—such as judicial appointments—but he would be able to block most efforts to roll back the actions his administration has taken so far. Meanwhile, Democrats would be unable to advance their own policy agenda against the president's wishes, since his veto power would still allow him to quash major market-impactful legislation from a Democratic Congress in even the most extreme 'blue wave' outcomes.

Still, there are a number of tangible policy and investment implications from the 2018 election that need to be considered. Of the four scenarios that we outline below, three have a neutral to positive market impact, while the Blue wave scenario could bring about an extreme form of gridlock that poses risks to both the durability of the expansion and sustainability of the bull market.

In other words, while the range of outcomes is much more limited than the 'fork in the road' decision faced by voters (and investors) in 2016, the midterms do matter.

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Assessing the scenarios

Midterms are often viewed as a referendum on the party in power, especially when it controls both the legislative and executive branches. And even though President Trump's name won't be on the ballot, there is little doubt that it will be front and center in virtually every congressional campaign and on the mind of most voters as they walk into the voting booth.

> "Both parties will focus on issues that excite their political bases in an effort to encourage them to vote in the elections."
>
> **—John Savercool**
> Head of the UBS US Office of Public Policy
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During past midterm elections, the electorate has tended to swing against the incumbent party with an average loss of 31 House seats for the sitting president's party. Considering that Republicans currently hold just 236 of the 435 seats in the House of Representatives—and they need at least 218 votes to keep a majority—they can only afford to lose 17 seats. Therefore, they would need to deliver a better-than-average performance in the November elections in order to maintain control. If the backlash against Republicans proves especially strong, it could be much worse. Keep in mind that during the 1994 midterms in Clinton's first term in office, the Democrats lost a total of 54 seats along with their congressional majority.

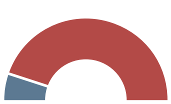
Assorted betting and political prediction market sites appear to confirm the challenging outlook for House Republicans this time around as well, pegging the odds of a Democratic majority at around 65%. While GOP leaders may take some solace in the fact that betting sites' data are volatile—and have delivered mixed results in the past—there are many other signs that the current political landscape appears to favor the Democrats.

In the Senate, Republicans hold only a one-seat majority, but the electoral math there is more favorable for the GOP. Unlike the House—where each member has to run for re-election every two years—Senate terms last six years, so there are three staggered terms with only one-third of the legislative body up for election each electoral cycle. As a result of this dynamic, the Senate experiences much less turnover than the House. The incumbent president's party loses an average of only four Senate seats during midterms.

This year's class of incumbent Senators is heavily Democratic, meaning that they're under more pressure to hold their seats. 25 Democrats (including 'Independents' Angus King and Bernie Sanders who caucus with the Democrats) are fighting to keep their seats, vs. just eight total Republicans. So even though the Republicans' majority is even thinner in the Senate, this asymmetry means that it's unlikely that the Democrats will have enough votes to flip the Senate. If they do, this suggests a significant voting advantage that would almost certainly also give them control of the House.

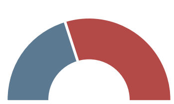
With all of this in mind—and the caveat that there are still about two months until the election—how can we begin to handicap the prospects for each party this November?

Scenarios



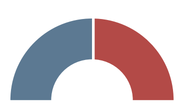
Red tide
(2% probability)

Republicans expand the size of their majority.



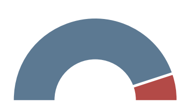
Status quo
(18% probability)

Republicans keep their majority in both chambers of Congress.



Historical norm
(60% probability)

In an historically average result, Democrats pick up a modest majority in the House, but Republicans control the Senate.



Blue wave
(20% probability)

In addition to building a sizable majority in the House, Democrats gain control of the Senate.

Approval

First, we look to approval polls. One popular litmus test is the so-called 'generic ballot' question, where likely voters from around the country are asked whether they plan to pull the lever for a Republican or a Democrat. Historically, this has had some correlation with actual election outcomes (see Fig. 1), but there are exceptions—most notably, 1994 and 2010. This year, Democrats hold a roughly 7% advantage based on this metric.

> "If voter discontent with Trump personally is a stronger sentiment than his results (mostly the solid economy), Democrats will make significant gains."
>
> —**John Savercool**
> Head of the UBS US Office of Public Policy
>
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Surprisingly, we find a more consistent relationship when we look at presidential approval polls (see Fig. 2). That's not great news for the GOP, because Gallup currently puts President Trump's approval rating near 41%, which would be the second-lowest approval rating for a sitting president during a midterm since 1958. Only President George W. Bush's approval rating was lower, at 37% during the 2006 midterms when the GOP lost 30 seats. Based on this figure alone, it would appear that Republicans face a challenging landscape in November.

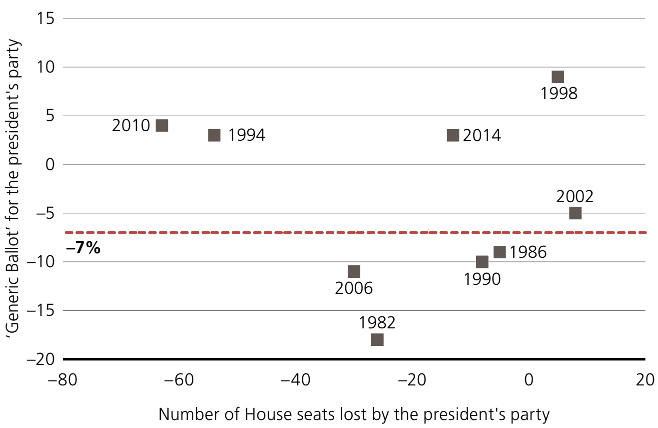
Even so, much of President Trump's unpopularity comes from Democratic voters and he remains exceptionally popular among Republicans—who largely credit him with a strong economy, passage of a sweeping tax reform plan, and record highs for the stock market. At 87%, President Trump currently enjoys as much popularity among Republicans as any previous president, lagging just behind President George W. Bush's 91% approval just before the 2002 midterms. Independent voters' support, meanwhile, has been fairly stable at 35-40%, which is in line with the readings at this point of President Obama's and President Clinton's first terms.

Turnout, therefore, will be a vital factor on Election Day. Without the 'star power' of the presidential ticket attracting voters to the polls, the average turnout in midterms has been just 39%—well below the 56% seen in presidential election years since 1980. Lower-turnout elections tend to favor the incumbent party, and Republican candidates tend to benefit the most because the biggest drop-off in participation usually occurs among demographic groups that traditionally lean toward the Democrats.

Fig. 1

"Do you plan to vote for a Republican or a Democrat?"

House seats lost by the president's party in midterms based on this 'generic ballot' question, 1982–2014, in %

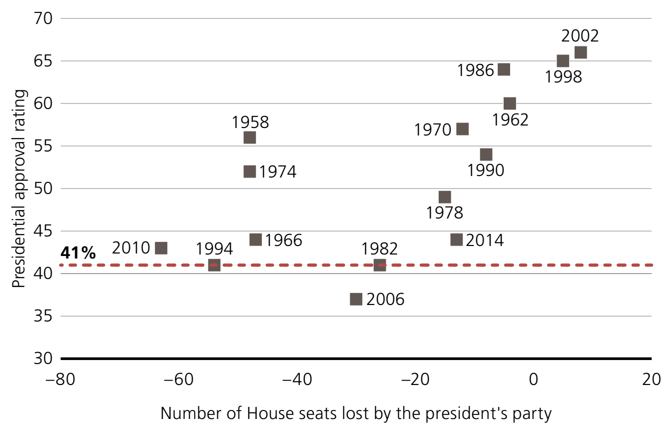


Source: Gallup, UBS, as of 31 August 2018.

Fig. 2

Presidential popularity tends to be a boon for their party

House seats lost by the president's party in midterms based on presidential approval rating, 1958–2014, in %



Source: Gallup, UBS, as of 31 August 2018.

How much do the Democrats need to win?

It's important to note that we've historically seen a discrepancy between the national vote split and the outcome of House races. Because of the way that the districts are drawn, and the fact that Democrats tend to live in tighter and more concentrated population clusters within cities, Democrats tend to win their districts by a larger margin than their Republican counterparts.

In 2016, Democratic representatives won with an average vote share of 67%, vs. just 64% for Republicans. As a result, Democrats tend to underperform the national vote when it comes to picking up House seats. For example, Republicans received about 49.3% of the popular vote in 2012 but captured 54% of House seats. If this trend continues, the Democrats would need to win about 53% of the vote in order to gain a majority in the House.

In the Senate, the math is a bit more complicated, since only one-third of the seats are contested in any given election. Due to the asymmetry of this year's election (25 Democrats fighting to keep their seats, vs. just eight Republicans), the Democrats would need an even larger—perhaps as much as 58% of votes cast—in order to pick up the two additional seats they'll need to secure a Senate majority. If the Republicans lose only one seat, they will still effectively hold on to their Senate majority, because Vice President Pence can cast a tie-breaking vote.

Strong economy

Historically, voters have been less likely to vote against the incumbent party when the economy is strong, and this could represent the best news of all for Republicans. At 3.9%, the unemployment rate is lower than it has been during the last 60 years of US midterms. And—going back to the earliest recordings of consumer sentiment and confidence—the economic mood is more optimistic than we've ever seen (see Fig. 3). Precedent suggests that this could help to shield Republicans against significant electoral losses.

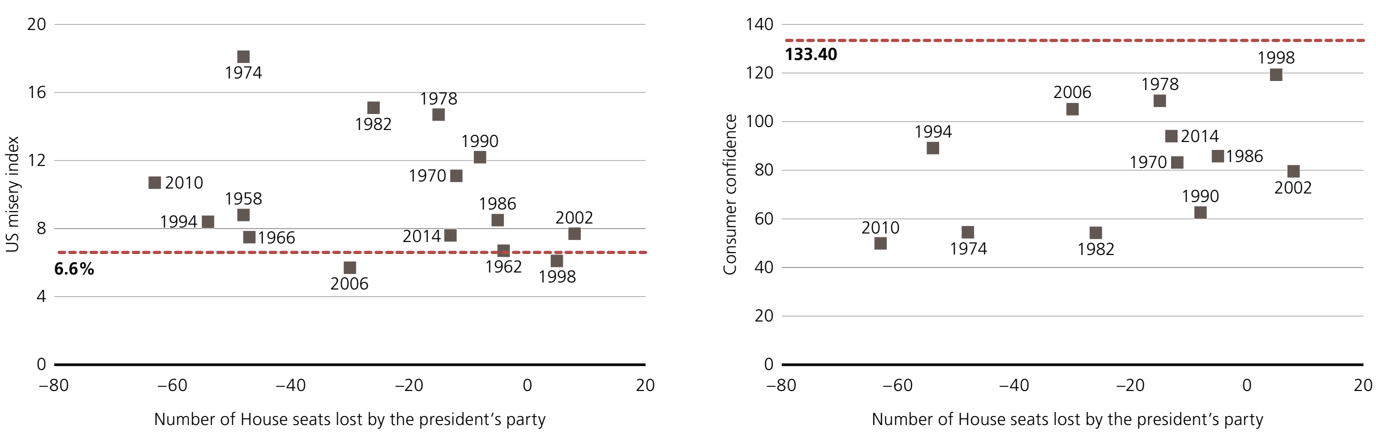
In the 1998 election—held amidst the impeachment proceedings of President Clinton—a booming economy allowed the incumbent Democrats to actually pick up five congressional seats. This was only the second time since the Civil War that the president's party gained seats in the House during a midterm.

Fig. 3

Republicans should benefit from the strongest economy in recent history

US Misery Index (Consumer Price Inflation + Unemployment rate)

Consumer confidence



Source: Bloomberg, UBS, as of 31 August 2018.

Incumbency

In what could be a sign of the political mood today, far more incumbent Republicans are retiring from office this election than Democrats. 37 Republican House members and three Senators have announced their intention to retire at the conclusion of the current term. By contrast, only 18 House Democrats are retiring, while all of the incumbent Democratic senators are running for re-election. Incumbents have historically enjoyed an Election Day advantage over challengers, and while this advantage varies significantly from election to election, it could represent the margin of victory in some key races. With so many Republicans choosing to retire instead of facing re-election, it could also be another signal that these races are vulnerable to a Democratic challenger.

Fig. 4

Democrats have outperformed in special elections

Special elections, by the seat's partisan lean and final vote margin

Date	Seat	Partisan Lean	Dem. Swing	Vote Margin
Senate				
12/12/2017	Alabama	R+29	31	D+2
House of Representatives				
4/4/2017	California 34th	D+69	18	D+87
4/11/2017	Kansas 4th	R+29	23	R+6
5/25/2017	Montana at large	R+21	16	R+6
6/20/2017	Georgia 6th	R+9	6	R+4
6/20/2017	South Carolina 5th	R+19	16	R+3
11/7/2017	Utah 3rd	R+35	3	R+32
3/13/2018	Pennsylvania 18th	R+21	22	D+0.3
4/24/2018	Arizona 8th	R+25	20	R+5
6/30/2018	Texas 27th	R+26	5	R+21
8/7/2018	Ohio 12th	R+14	13	R+1

Partisan lean is the difference between how each constituency voted in 2012 and 2016 and the nationwide average.

Source: Fivethirtyeight, Daily Kos Elections, Secretaries of State, UBS, as of 31 August 2018.

Special elections

Special elections—contests that have been held since the 2016 election to fill vacancies—are another gauge of sentiment. The Alabama Senate election dealt a particularly painful blow to the Republicans, cutting their majority to just one seat—one example of a strong pattern of Democrats performing better than expected. In fact, Democratic candidates have received 16% more of the vote share than their party managed in the 2012 and 2016 elections. The result has been a series of close races in deep-red territory and a handful of upsets (see Fig. 4).

Bottom Line

Combining all of these political and economic factors, we constructed a multi-variable regression model to estimate how the electoral fortunes might swing. Based on this result alone, the backdrop is slightly better than average for the Republicans, suggesting a loss of only 9-13 seats in the House.

But politics isn't a purely mathematical affair, and there are other factors that can't be quantified—for example, the higher-than-usual number of retiring Republicans, the tone set by special elections, and the unpredictability of turnout.

After weighing these variables and discussing the election with our policy experts in the UBS US Office of Public Policy—led by John Savercool—we estimate that Democrats will gain control of the House (a historically average outcome) but fall short of a Senate majority.

Since few can claim the ability to reliably predict elections—look no further than the Brexit vote and the 2016 US presidential election—humility is called for as we look forward to November. We therefore assess all of the possible scenarios to make sure that we consider the likely political, policy, and investment implications.

Policy possibilities and risks

What's possible under the Red tide and Status quo outcomes?

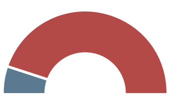
For the scenarios where Republicans manage to hold on to or add a few seats to their majorities, Republicans have a relatively clear path to push through their agenda items. This could be good on the margin for risk assets, since it reduces the risk that Congress will be too divided to be functional.

However, history tells us that Republicans will likely lose at least a few seats. Republicans have already struggled to pass legislation with their current make-up, and a thinner majority would further restrict their legislative possibilities. And since Democrats will almost certainly have at least the 40 votes needed to organize a filibuster in the Senate in this scenario, the so-called 'budget reconciliation' process may be Republicans' only pathway for passing major legislation.

So based on both the campaign rhetoric and electoral realities, we expect the GOP would be forced to resort to reconciliation in order to pass 'Tax reform 2.0,' a measure that would make the personal tax changes of the 2018 tax bill permanent.

In addition, we would also expect Republicans to tackle the deficit by cutting government spending elsewhere. Having already proposed significant cuts to non-defense discretionary spending, entitlement spending would be a prominent target. The GOP has long favored an approach that scales back the federal government's role in programs like Medicare and Medicaid.

Political environment

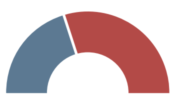


Red tide
(2% probability)

With an increased majority, Republicans are able to pass legislation that eluded them in the first half of President Trump's first term. Republicans push hard on making the personal tax cuts permanent, and consider lowering capital gains taxes, while also looking at ways to cut government spending through entitlement reform.

President Trump and Congress act in concert to loosen regulations, making additional cuts to Obama-era policies and laws such as Dodd-Frank.

Emboldened by the election result, the president redoubles his efforts on addressing the US trade deficit by imposing import tariffs.

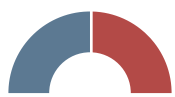


Status quo
(18% probability)

Republicans continue to pass legislation over Democratic opposition, using 'budget reconciliation' once a year to bypass a Democratic filibuster for major bills.

A major priority will be trying to make the personal tax cuts permanent. Republicans also may try to lower capital gains taxes and cut government spending through entitlement reform, but these will be even bigger lifts.

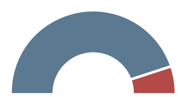
President Trump continues to use executive actions to loosen regulations, and to use tariffs to pressure trading partners.



Historical norm
(60% probability)

Gridlock develops, requiring compromise to pass most major legislation. Democrats launch myriad investigations against the Trump administration.

President Trump continues to use executive actions to loosen regulations, and to use tariffs to pressure trading partners.



Blue wave
(20% probability)

Congress struggles to pass any legislation. Democrats launch myriad investigations against the Trump administration, and refuse to confirm many judicial appointees, including Supreme Court justices.

Democrats lack the votes to overcome President Trump's vetoes, leaving Congress in an extreme form of gridlock. Both parties try to push through policy priorities using ultimatums, increasing the risk of government shutdowns and even another 2011 debt ceiling crisis.

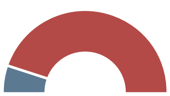
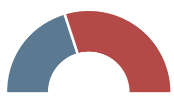
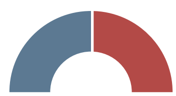
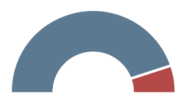
President Trump continues to use executive actions to loosen regulations, and to use tariffs to pressure trading partners.

In the Historical norm scenario, would gridlock be good?

One school of thought says that moving away from a unified government would be good for markets and the economy. After all, there are plenty of instances where the economy flourished and markets prospered when neither party was able to push through imprudent policy measures or ill-conceived legislative proposals. With the economy already operating close to its full potential, and concerns mounting over further pro-cyclical fiscal measures, it's less important for Congress to be able to easily pass major legislation, including additional tax cuts that could further widen the deficit. Keep in mind that the only budget surpluses in the last half-century were achieved by a divided government under the Clinton administration.

However, a change in leadership could also usher in a period of even greater political dysfunction. Democratic control of key committee chairmanships would likely launch a series of investigations into a whole host of issues related to the Trump administration. This could unsettle markets from time to time as the focus shifts to congressional hearings and talk of impeachment. Still, it's important to keep in mind that most political scandals typically don't have a meaningful or lasting impact upon economic growth or financial markets.

Policy possibilities

	Red tide (2% probability)	**Status quo** (18% probability)	**Historical norm** (60% probability)	**Blue wave** (20% probability)
Likely	• Entitlement reform • Tax reform 2.0 • Regulatory relief accelerates • Infrastructure • Border wall	• Regulatory relief continues • Border wall	• Gridlock • Regulatory relief continues • Government shutdown	• Extreme gridlock • Regulatory relief slows • Government shutdown • Supreme Court freeze
Possible	• Obamacare repeal	• Entitlement reform • Tax reform 2.0 • Obamacare repeal • Gridlock • Infrastructure • Drug price controls	• Impeachment (but removal unlikely) • Infrastructure • Drug price controls • Supreme Court freeze	• Debt ceiling showdown • Congress constrains trade authority • Impeachment (but removal unlikely) • Infrastructure • Drug price controls
Unlikely	• Debt ceiling showdown • Gridlock • Congress constrains trade authority • Government shutdown • Impeachment or removal • Drug price controls • Supreme Court freeze	• Debt ceiling showdown • Congress constrains trade authority • Government shutdown • Impeachment or removal • Supreme Court freeze	• Entitlement reform • Tax reform 2.0 • Debt ceiling showdown • Congress constrains trade authority • Obamacare repeal • Border wall	• Entitlement reform • Tax reform 2.0 • Obamacare repeal • Border wall

What are the risks of the Blue wave scenario?

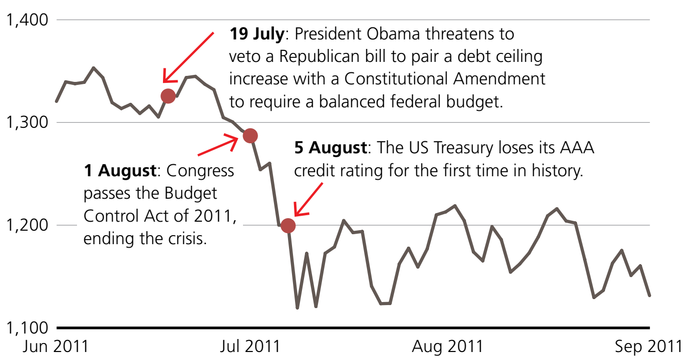
It's important to note that the Democrats cannot capture enough Senate seats to pass major legislation without Republican help. Even in the extremely unlikely scenario where Democrats defeat all eight Republican Senators up for re-election, they will still only hold 57 seats—a seven-seat majority that falls short of the 60-vote threshold required to overcome a filibuster and well below the two-thirds supermajority needed to override a presidential veto.

But while a 'mild gridlock' outcome could be benign or even positive for markets, extreme gridlock could pose serious risks. Congress will need to act to avoid a fiscal cliff when the current government spending agreement expires in September 2019. If the two parties can't find common ground, a showdown over the budget could significantly disrupt markets.

Fig. 5

The S&P 500 fell 18% during the 2011 debt ceiling crisis

S&P 500 index level



Source: Bloomberg, UBS, as of 4 September 2018.

Shutdowns and showdowns

Temporary government shutdowns are fairly common and haven't historically impacted financial markets, but debt ceiling crises are another matter. During the 2011 debt ceiling crisis, Republicans refused to raise the debt ceiling without an agreement to cut government spending. This period of uncertainty—which nearly caused the US Treasury to default on paying its obligations—coincided with the largest bout of volatility since the Global Financial Crisis, and a nearly 20% drop in the S&P 500, before it was ultimately resolved (see Fig. 5). It's important to note that the 2011 market reaction was also exacerbated by a simultaneous flare-up in the Eurozone debt crisis. In late 2013, when the US was once again close to breaching the debt ceiling, the S&P 500 experienced only a 4% drop during negotiations.

In the years since then, numerous government shutdowns have occurred due to a lack of common ground on government spending priorities. These episodes have all ended with a compromise that has tended toward increased government spending—and that avenue may be less feasible given the already-high level of deficit spending. This means that a repeat of the near-miss in 2011 is not only possible but could actually become likely in an extreme gridlock environment.

Is impeachment a risk?

Political prediction sites put the probability of President Trump completing his first term at 65%, suggesting that many expect a risk of impeachment if Democrats were to win the House. Even so, a scenario where Trump is removed from office looks highly unlikely at the moment.

Even if Democrats find the votes to impeach in the House—which becomes possible if they capture a majority in that chamber this November—they would also need to convict President Trump in the Senate to remove him from office. Conviction requires a two-thirds supermajority (67 votes), meaning that Democrats would need to convince a dozen or more Republicans to cross the aisle for the vote—only possible in the most extreme of scenarios.

"Most Democrats in Congress would relish an opportunity to pursue impeachment proceedings, but feel they need a stronger basis for doing so than exists now."

—John Savercool
Head of the UBS US Office of Public Policy

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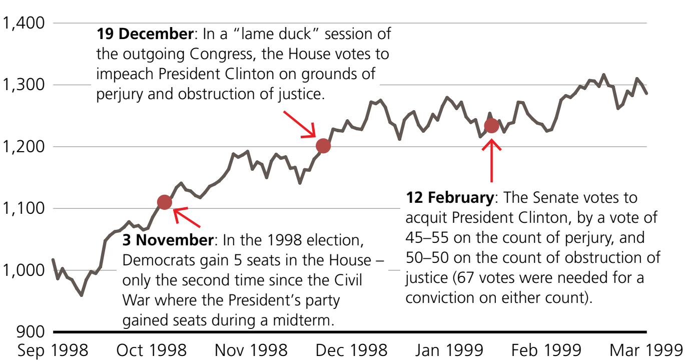
Only two sitting presidents have been impeached by the House: Andrew Johnson in 1868, and Bill Clinton in 1998. Neither president was ultimately removed from office, as the Senate failed to convict them by the required two-thirds supermajority. Richard Nixon resigned before impeachment proceedings were brought to a vote.

So far, Democrats have campaigned on the promise of investigations, and key party leaders have downplayed talk of impeachment as 'premature.' That will change if their investigations—or the special prosecutor's report— identify charges that fit one of the Constitution's parameters: 'treason, bribery, or other high crimes and misdemeanors.'

Fig. 6

Markets didn't blink after the 1998 impeachment

S&P 500 Index level



Source: Bloomberg, UBS, as of 4 September 2018.

But as we've noted, while House Democrats could theoretically impeach the president without any Republican votes, there is a much higher hurdle for a conviction in the Senate. There would be a high threshold of evidence before any Republican joins Democrats in such a vote, and more than a dozen defections would be needed to reach the 67-vote threshold.

Limited market risk

Putting aside the likelihood and political implications for a moment, would this scenario be a material market risk? The act of impeachment could certainly increase the risk of extreme gridlock, but markets didn't seem to react materially to the Clinton-era impeachment proceedings. In fact, markets continued to grind higher following the impeachment proceedings right through to the end of Clinton's second term in office (see Fig. 6).

One risk of course is that a wounded President Trump would lash out at his adversaries—both at home and abroad—in response to impeachment proceedings. But while the president still retains a great deal of power through his executive authority, both the legislative and judicial branches have the ability to place certain checks on the executive branch's ability to take actions that could harm the country's economy and/or destabilize markets.

Even in the unlikely instance where a Senate conviction ends President Trump's term early and Vice President Mike Pence would take the reins, the market impact may still be limited. His record suggests a reliably conservative approach that would continue the current status quo trend of the Trump administration.

Markets may even find a Pence presidency to be a modest positive on at least one front: Trade. During his time in the House, Pence voted for every free-trade agreement that came before him, suggesting that he would likely dial back some of trade rhetoric and potentially undo some of the tariffs already in place.

But while this would hypothetically help to calm markets, we would certainly expect political dysfunction to represent a risk in this scenario. Bipartisanship—already rare today—could become critically endangered in the aftermath of such a politically charged procedure. Markets would eventually look past this dysfunction but some sort of negative market reaction would be likely in the short term.

Investment implications

It's important to note that the next Congress is very unlikely to undo the major market-impactful legislation that has already been passed under President Trump.

The fiscal stimulus from tax reform and increased government spending will continue to boost economic growth through 2019, while the benefits of looser regulation are continuing to work their way through many sectors of the economy as well. That's good news for US stocks, which would be a lot more worried about a 'blue wave' if it carried the possibility of drastic policy shifts such as tax hikes. And while international stock markets benefitted from US fiscal stimulus, they have also been negatively affected by the fallout from other Trump administration policies, including rising trade tensions, higher Treasury yields, and a stronger US dollar.

> "I believe Congress would weigh in strongly if the President decided to withdraw the US from NAFTA."
>
> **—John Savercool**
> Head of the UBS US Office of Public Policy

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For investors looking for relief from these trends, the midterms are not a likely catalyst. After all, President Trump will remain the most important variable for what policies can be put into place, regardless of the midterm election result.

That's especially true because of this year's class of Senate seats. Even if the Democrats were to sweep every election in the Senate, they will only be able to pick up eight seats from Republicans. This falls well short of the 67 votes needed overcome a presidential veto. And—unless the Republicans manage a historic upset—neither party will have the 60 votes needed to overcome a filibuster in the Senate. The Senate, therefore, is the key limiting factor for what policies are possible before the 2020 election.

With this in mind, this election is really about how dysfunctional Washington will be for the second half of President Trump's first term. While it's possible that President Trump will find selective pockets of compromise with congressional Democrats, it's more likely that the divided government outcomes would cause the DC policymaking process to grind to a halt.

Could the midterms help cool trade tensions?

Many international investors may be watching the 2018 midterms with the hope that Congress will rein in the Trump administration's more aggressive trade policies. However, this appears unlikely.

While Congress does have control to grant approval of trade agreements, it has often ceded negotiation authority to the executive branch. In fact, despite ongoing trade tensions, Congress recently agreed to an extension of the so-called 'fast track' trade authority, wherein Congress agrees to give any proposed trade agreement a simple 'up or down' vote, without amendments. This gives President Trump the latitude to negotiate trade agreements unilaterally.

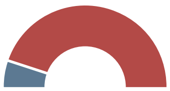
So far, President Trump has relied on two main laws to unilaterally apply import tariffs: Section 232 of the Trade Expansion Act of 1962 (used for 'national security' in the case of tariffs on steel and aluminum and proposed auto import tariffs) and Section 301 of the Trade Act of 1974 (used to redress theft of US intellectual property, in the case of tariffs on Chinese imports). Congress could amend these laws to require the president to seek Congress's advice and consent, but hasn't done so yet.

While free trade has been a long-standing part of Republicans' policy platform, trade is an issue that both parties treat on a case-by-case basis, and every modern US administration—regardless of party—has used trade tariffs and quotas as policy tools.

Working-class Democrats have long been advocates of a tough approach on trade, but the Democratic Party has often embraced free-trade agreements. After all, President Bill Clinton negotiated the original North American Free Trade Agreement (NAFTA) in 1993, while President Barack Obama was a fierce advocate of US participation in the 12-country Trans-Pacific Partnership (TPP).

Therefore, we don't expect Democrats to push back against the president if it looks like he's winning. That being said, there is a possibility that the Democrats will seize upon a political opportunity to rein in the Trump administration if it looks like he's made a misstep in negotiations or if there is a sizable negative economic impact.

Investment implications



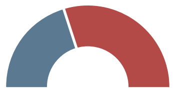
Red tide
(2% probability)

Market impact (risk assets): +

Tax reform 2.0 & entitlement reform - By pairing these proposals, Republicans add short-term fiscal stimulus while addressing long-term concerns about the deficit. This should boost global stock markets, limit increases in long-term bond yields, and support the US dollar.

Regulatory relief accelerates - Domestic-oriented sectors and smaller-cap stocks benefit most from regulatory relief via executive action. Financials benefit from moves to repeal parts of Dodd-Frank.

Obamacare repeal - Hospitals and insurers are negatively affected, but little impact on the rest of the market.

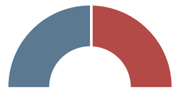


Status quo
(18% probability)

Market impact (risk assets): +

Modest relief rally - While it's difficult to tell if markets are appropriately pricing in concern about potential gridlock, they may well experience a modest post-election rally if Republicans hold onto their majorities, if only because it reduces the risk of extreme gridlock and dysfunction.

Tax reform 2.0 is still possible, but there is a narrower scope for entitlement reform due to a smaller majority. This scenario carries a higher risk of deficit-financed spending or tax cuts, which adds short-term stimulus and benefits risk assets, but also puts upward pressure on long-term government bond yields and could weaken the US dollar.



Historical norm
(60% probability)

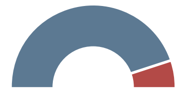
Market impact (risk assets): =

Gridlock, with pockets of compromise - Without common ground on areas to cut spending, the budget deficit remains higher than usual, putting upward pressure on long-term government bond yields.

Infrastructure is one area where President Trump and Democrats may find common ground, but they tend to disagree on size, substance, and funding. This would be a modest positive for risk assets (especially a basket of infrastructure-related companies), but add to pressure on bond yields and the US dollar if the package is largely deficit-financed.

Government shutdowns are likely in this scenario, but markets have historically shown very little reaction to these episodes.

Drug price controls are a possible area of compromise, and would weigh on global pharmaceuticals.



Blue wave
(20% probability)

Market impact (risk assets): = / −

Extreme gridlock - Last-minute deals become more common, leaving markets jittery—especially where the debt ceiling is concerned.

Trade restrictions - In an extreme case, Congress could reach a bipartisan agreement to restrict President Trump's authority to impose tariffs and other trade barriers. This would help reduce downside risk for US multinationals and international stocks, and put downward pressure on the US dollar.

Impeachment - If Democrats move to impeach President Trump in the House without Republican support, there could be a short-term selloff in risk assets. However, given the high probability of acquittal in the Senate, there will likely be little to no lasting market impact.

John Savercool on the 2018 midterms

Thoughts from the UBS US Office of Public Policy

John Savercool
Head of the UBS US
Office of Public Policy

UBS Chief Investment Office: What is the likelihood that Congress moves on trade legislation to restrict presidential authority to enact tariffs unilaterally?

John Savercool: While many Republicans and Democrats in Congress oppose President Trump's actions to impose new tariffs on many US trade partners, I do not expect Congress to enact legislation to seriously restrict the president's ability to levy these or additional tariffs. There was a strong bipartisan vote in the Senate recently to rebuke President Trump on trade issues, but this vote was symbolic and a vote on a stronger bill would have had a much different outcome. Even if a stronger measure were to pass, President Trump would veto it and there would not be enough support to override his veto.

While I don't expect legislative action to reverse any of the Trump tariff actions, I believe Congress would weigh in strongly if the President decided to withdraw the US from NAFTA. I don't envision the President taking this action, but I think this issue presents a greater risk to congressional counteraction than the tariff issues.

UBS CIO: In your view, how will the Mueller investigation impact the election?

John Savercool: The investigation's findings could be this year's 'October surprise' but I believe a more likely scenario is that the investigation will continue to generate drama and cable TV fodder but will not dramatically impact the election results. Most Americans are aware of the investigation and have already made up their minds about the president, the Mueller team, the FBI, Russian interference in the elections and other related issues. Serious charges of specific illegal activity against the president or a family member could change the dynamics of the situation and hurt Republicans, but to date I have not seen any evidence that any such charges are forthcoming. The big unknown is how long Mueller will let this investigation continue. He has such a broad investigation mandate that this would suggest a much longer investigation, but I also don't believe that he wants to prolong his work and conclude it on the eve of the elections.

UBS CIO: How disruptive would you expect investigations and hearings to be under each election outcome? Do you think impeachment is a real possibility in the 'gridlock' scenario, or would this only happen if the Democrats hold both chambers of Congress?

John Savercool: If Democrats take control of either chamber of Congress, they will use the committees' power to investigate to the full extent. Their primary investigative target will be the activities and policies of the Trump administration. Many high-level Trump administration officials will be hauled up to Congress to have their work publicly scrutinized (and criticized), while others will not appear and be held in contempt, as were various Bush and Obama officials. This type of oversight will be a key part of any Democratic strategy in any chamber they control for the next two years.

Impeachment proceedings could occur if Democrats believe that they're warranted by the Mueller investigation's conclusions. Most Democrats in Congress would relish an opportunity to pursue impeachment proceedings, but feel they need a stronger basis for doing so than exists now. If the Mueller report gives them more ammunition, I expect this to be a big issue in 2019. While the House under Democratic control could initiate this activity, I doubt very much the Senate would follow suit and believe impeachment will have very little overall traction next year.

UBS CIO: If Republicans hold onto majorities in both chambers, what legislation are they likely to pursue? Can they use reconciliation to pass entitlement reform or to make the personal tax cuts permanent?

John Savercool: If Republicans retain control of Congress, they will continue to pursue many of the issues they are currently working on. At the top of the agenda will be further deregulation, a follow-up tax reform and relief bill, border security improvements (including funding for the wall), healthcare reforms and possibly a deficit reduction package, among others. Entitlement program reforms will be discussed as the deficit continues to widen but are unlikely as the 2020 presidential election nears. Overall, the agenda would be ambitious but results would be limited since any Republican majority is likely to be smaller than it is now.

Budget reconciliation would likely be used to pursue a follow-up tax bill. The core of such a tax bill would be to make the individual tax cuts made in last year's comprehensive tax reform bill permanent. Some Republicans may want to use reconciliation to enact an alternative to Obamacare, but until there is a clear consensus on what that alternative should be, I don't expect that to happen.

UBS CIO: What should we be watching between now and Election Day? What are the key issues that you think could help shape the results?

John Savercool: Over the next couple of months, both parties will focus on issues that excite their political bases in an effort to encourage them to vote in the elections. Republicans still control the agenda in the House and Senate and will try to pass bills that reinforce the good news surrounding the economy. A strong economy, due to tax reforms and deregulation, is their best accomplishment to tout heading into November and they will relentlessly highlight it. Democrats will counter with healthcare initiatives, less stringent immigration proposals, and a charge of Republican 'corruption,' as underscored in the recent charging of Congressman Chris Collins (R-NY) with insider trading. The Mueller investigation could give them more ammunition in this regard. Democrats will also focus on President Trump's governing style, while Republicans will focus on his policy results, not the style that surrounds them. While Democrats will focus on the president, Republicans will work to tie their opponents to House Minority Leader Nancy Pelosi, the long-time House Democratic leader who polls poorly with most voters nationally.

Democrats seem to have more enthusiasm for voting in the midterm elections at this time, which gives them an advantage in many of the competitive House and Senate seats. That could change, however, over the next 75 days. Wild cards can always emerge, and any wild cards over the next few months will likely be related to the Mueller investigation, in foreign policy or in developments with the tariff disputes that separate the US and trade partners.

The election results will all come down to voter perceptions of President Trump. If they like his policies and either like his governing style or can overlook it in deference to his policy results, Republicans can hold their own in the elections. If voter discontent with Trump personally is a stronger sentiment than his results (mostly the solid economy), Democrats will make significant gains and likely hold a majority in at least one chamber next year.

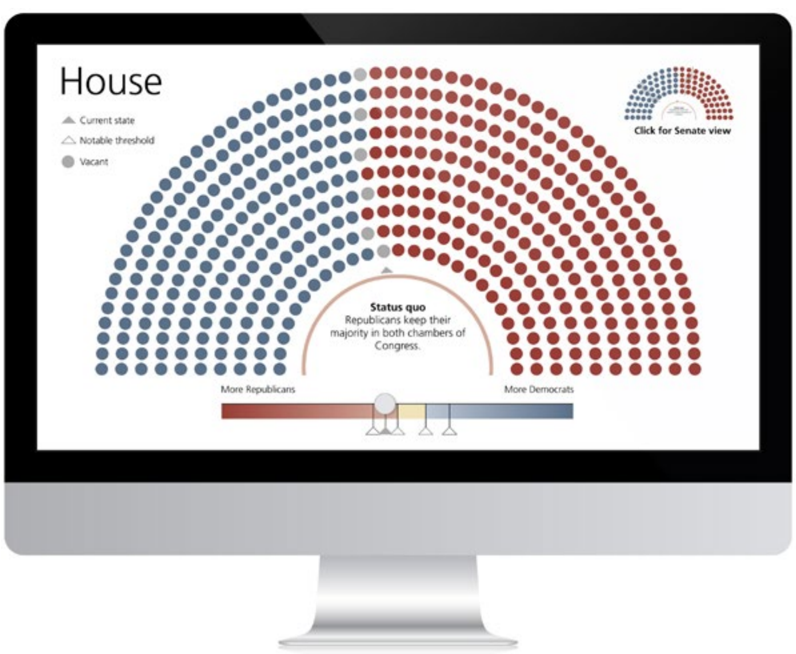
2020 foresight

As premature as this may be, November's elections will lay the stage for the 2020 presidential election. If the Republicans are able to win an historic upset, they will have another two years to make the case that a unified Republican government can be productive and good for the country.

If Congress swings in the favor of the Democrats, both parties will spend the next two years painting their opposition as obstructionist. The resulting struggle could bring a pick-up in political dysfunction and increase the risk of inaction at a time when legislation is urgently needed.

Another question is whether the 2018 midterms will enhance or reduce President Trump's influence on the broader Republican Party. Because of his popularity among Republicans, the president has shown an ability to sway primary elections—so far, all but two of his 37 endorsements have led to successful campaigns. And while there have been some high-profile Republican defections on issues such as healthcare and immigration, there hasn't been a unified stand against President Trump's challenges to long-standing GOP policy planks such as fiscal conservatism, free-trade advocacy, and a hawkish approach to foreign policy.

If the elections do reinvigorate an internal Republican opposition—which could include a primary challenge to Trump in 2020—it's not clear who the standard-bearer could be. The late Senator John McCain was one of the president's greatest adversaries in the party, but his replacement will be more likely to vote with the rest of the party. Meanwhile, House Speaker Paul Ryan and many other prominent Republicans are retiring; they are largely being replaced by more junior rank-and-file members, leaving a power vacuum that suggests that the party will continue to drift toward President Trump.



Stay engaged!
In the coming months, we'll continue to evaluate and assess how the election possibilities and risks will impact the real economy and financial markets. Please visit us at **ubs.com/electionwatch** to join the conversation, and to take a tour of our up-to-date analysis on the scenarios, policy possibilities, and investment implications.

Publication details

Publisher
UBS Financial Services Inc.
CIO Global Wealth Management
1285 Avenue of the Americas, 20th Floor
New York, NY 10019

Authors
Mike Ryan
Justin Waring

Contributors outside CIO
John Savercool
Shane Lieberman
John Nolan

Editors
Kate Hazelwood

Project management
John Collura
Paul Leeming
Matt Siegel

Report design
Cheryl Seligman

Graphics support
Cognizant Group
Basavaraj Gudihal
Srinivas Addugula
Pavan Mekala
Virender Negi

Photos
iStock

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Version as per April 2018.