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# US midterms: short-term news with long-term implications

Looking at geopolitics and investing in light of the US elections  
and the Communist Party Congress in China



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**How will the world's economic and political situation unfold in the wake of the upcoming US midterm elections? On November 8, Americans will decide who sits in Congress, with the membership of both the House of Representatives and the Senate put to the vote. It is an election taking place amid great uncertainty. The Covid-19 pandemic brought an unprecedented crisis on a global scale and, after weathering this storm, world leaders are now facing a slew of new challenges. There are no signs of a peaceful resolution to the war in Ukraine on the horizon, with the geopolitical situation further exacerbating high energy prices and strong inflation in large parts of the globe, particularly in Europe. And it's not just the US where leadership decisions are currently being made. China, another global powerhouse, saw the 20th National Congress of the Chinese Communist Party from October 16 – 22, with the reelection of Xi Jinping cementing the nation's leadership path for the remainder of this decade. This paper considers potential outcomes of the US midterms and what the resulting scenarios could mean for investors, both within the US and globally, also in light of the latest news from the Communist Party congress in China.**

# Key takeaways for investors

The US midterms appear likely to result in the outcome of a divided government, as current opinion polls point toward either a split Congress or a Republican-controlled Congress, both currently polling at a probability of around 40%. A divided government would likely lead to a stalemate in US politics, reducing the odds of significant fiscal changes and thereby lowering uncertainty among investors and the markets. However, a divided government would increase the risk of a government shutdown during the next year, the effects of which could temporarily weigh on financial markets.

A blue sweep, in which the Democrats remain in control of both chambers of Congress and retain full control of the government, currently polls at a likelihood of about 20%. It is the scenario most likely to breed uncertainty among investors, as it could lead to increased fiscal spending and further regulation of the environmental and tech sectors. On the other hand, in the event of a recession, governmental support would likely be more rapid and forceful under a unified government compared with a divided government. Such a Democrat-controlled government is expected to swiftly support economic growth and improve investor sentiment, as a recession is usually a bad harbinger for a party that wants to see its president reelected. Yet, this approach could conflict with the US central bank's current restrictive monetary policy aimed at reducing inflation by dampening economic activity.

A red sweep, in contrast, would see the Republicans take control of both chambers of Congress and allow them to roll back Democrat-introduced fiscal legislation and reduce fiscal spending. Although we don't expect major changes during the next 2 years, if all else remains equal, a reduction in fiscal spending would likely translate into reduced growth expectations among investors. During a period of extended weak growth or recession, any changes to fiscal legislation or spending would be of particular importance.

A meaningful change in US foreign policy seems unlikely to arise regardless of the midterm election results. Strong bipartisan views exist when it comes to defending the US' position as a global leader. Having said that, if a red sweep were to occur and President Biden would become politically isolated in government, he may become increasingly active in areas he can exercise greater unilateral control, such as foreign policy, as the Republicans will likely challenge him in issues requiring direct congressional approval, such as domestic policy issues. On the other hand, if the midterms see Trump-backed Republicans win their Senate or House races, investors might start to speculate whether the former President or a "Trump wing"-Republican could win the 2024 presidential elections and potentially challenge the current consensus in US foreign policy.

The current level of geopolitical uncertainty is likely to continue over the long term, taking the possible US election results and the latest developments in China into account. If they do occur, any potential reductions to the current levels of geopolitical tensions will likely be short-lived: Xi Jinping's statements at the last Chinese Communist Party Congress indicated focusing less on economic growth and more on security issues, while bipartisan support exists in the US to defend the country's global predominance. Investors will likely face years of volatile and elevated geopolitical uncertainty that will affect both the global economy and financial markets.

# The US midterms in a nutshell

In the US midterm elections, which take place halfway through a president's four-year term, all members of the House of Representatives and a third of the Senate are elected at a federal level. There are 435 seats in the House of Representatives and 100 seats in the Senate. Currently, Democrats form a unified government as they are in control of the White House under President Joe Biden, as well as both chambers of Congress. However, they lack a comfortable majority in both the House and the Senate. They're just six seats ahead in the House, while the Senate is evenly split; the only reason they collectively hold the majority in the Senate is because of the casting vote given to the Vice President, in this case, Kamala Harris. But the thin majority has affected the Democrats' ability to reform and push their agenda as party outliers, such as Senator Joe Manchin of West Virginia or Senator Kyrsten Sinema of Arizona, have often opposed party plans, resulting in watered-down or scuttled bills.

In addition to the congressional elections, numerous other state and local elections are also going to be held on November 8. While elections at the federal level are the most important ones in terms of political and economic impact, the outcome of state and local elections can also exert influence when it comes to public opinion ahead of the 2024 presidential elections and indicate potential shifts in the political landscape of the US.

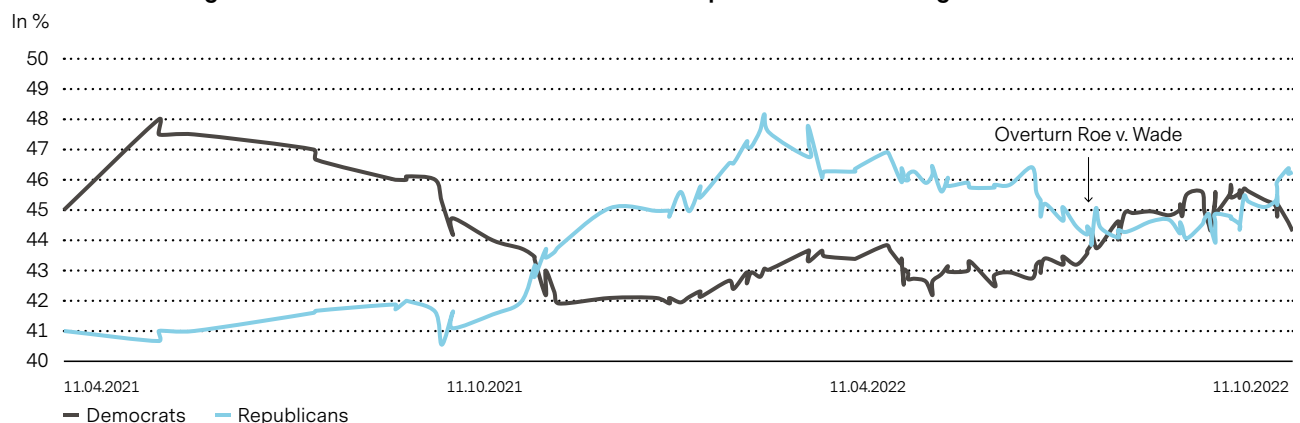
## Our expectation:

### a government divided by a split Congress

Since the end of 2021, it has seemed likely that Republicans would take control of both the House and Senate this November—a so-called red sweep. However, the tide started to turn in June when the US Supreme Court decided to overturn *Roe v. Wade*, effectively removing the constitutional right to abortion and paving the way for abortion bans across the country (see chart 1). The Supreme Court's move triggered an anti-Republican reaction among several voter blocs and led to a wave of new voter registrations, many of whom are women. Still, the senate race between the parties remains a nail-biter as we edge closer to the midterms, with Republicans appearing to have regained some of the momentum they lost over the American summer. It seems that the Republicans, however, will take the House of Representatives, according to the current polling.

Taking all of this into consideration, we currently expect that there is about an 80% probability of a divided government where the Republicans take control of at least one chamber of Congress and end the unified government in Democratic hands. This could happen in one of two ways, with opinion polls predicting a likelihood of about 45% for a split Congress, also referred to as a divided Congress, in which the Republicans take one chamber and the Democrats the other; or, with a probability of about 35%, red sweep, where the Republicans win both chambers. At a current likelihood of 20%, a low-probability scenario would be a so-called blue sweep, with the Democrats taking control of both the House and Senate and remaining in full control of US politics under a unified government.

**Chart 1: Percentage of voters that want to see Democrats or Republicans in the Congress**



Source: FiveThirtyEight, Vontobel

# How the midterms can affect the economy

Democrats and Republicans are divided over many topics, including areas such as public spending on climate programs and social issues. If Republicans take at least one chamber of Congress this November, resulting in a divided government, they are likely to restrict President Biden's spending on such public initiatives. Republicans have previously used their balance of power in Congress to strong-arm Democrats into making concessions, such as using the country's debt ceiling to oppose any spending that is important to the Democratic party. Of course, such tactics have also been used by the Democrats in similar situations under a Republican presidency. Keeping this in mind, let's consider the three midterm election result scenarios discussed above.

## The challenges a divided Congress could bring

The biggest change to the current status quo (of a unified government under Democratic leadership) will take place if the Republicans regain control over at least one of the two chambers, which would result in a divided government. This is because spending plans, like fiscal legislation, need to pass both the House and Senate. A divided government, in which power is split and the Republicans have the majority in one chamber and the Democrats in the other, makes it complicated for any president to govern, one example being the passing of budget proposals through Congress. How could this play out in reality? Well, if the opposing party (the Republicans) uses its leverage in Congress to block a smooth budget process for the Democratic president, a split Congress or a Congress unified in Republican hands could ultimately result in the risk of a government shutdown. This has happened previously during the turn of the year 2018/19, when Donald Trump, a Republican, tried to pass the budget in a divided Congress and the Democrats blocked it. Usually, as at the end of 2018, a government shutdown temporarily weighs on financial markets due to the increase in uncertainty about the changes to public spending and the furlough of federal workers, which naturally reduces public services as well as consumption.

Now, if the US economy were to slip into a recession, which is not unlikely in the context of the current tightening of the Federal Reserve's monetary policy and the elevated prices that consumers are currently facing, a quick response from the government in the form of more public spending to support the economy would become particularly important. However, a divided government makes securing the congressional blessing for additional government spending more difficult. If the US economy starts to weaken significantly, it's reasonable to expect that a divided government would lead to fewer rapid and substantial support measures than a unified (Democratic) government. This is what could make these midterms economically crucial in the current environment, as the economic outlook for the US and the world continues to deteriorate.

That said, it's worth noting that one of the Republican wings in Congress seems to be demonstrating reduced fiscal frugality. This already occurred under the Trump presidency, when the pandemic prompted a shift towards more fiscal support for the working class through the federal state. This could mean that, in the case of a divided Congress, fiscal packages proposed in the event of a recession would likely be pushed through, but with some delay. What's interesting here is that, historically, US presidents grappling with a recession one or two years before presidential elections are less likely to be elected. Hence, with the onset of a broad recession, Republicans may be faced with a conflict of interest between supporting the economy and increasing their likelihood of seeing a Republican president take over in 2024. Just think back to Democrat Bill Clinton's successful campaign run against George H.W. Bush (a one-term Republican president) in the early 90s, using the catchphrase "It's the economy, stupid" in reference to the Bush administration's handling of the recession at the time (see chart 2).

On the other hand, a divided government might prompt President Biden to act in areas where the Constitution

**Chart 2: Reelection probabilities of the incumbent US president looks dire in a recession scenario**

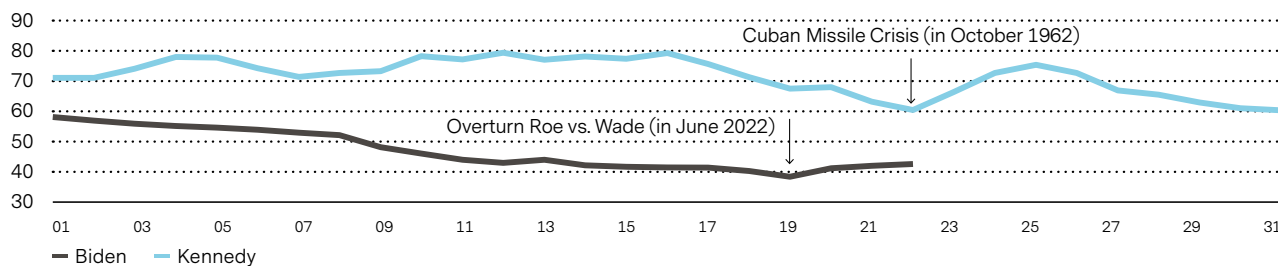
In %



Source: NBER, Federal Election Commission, Clerk of the House of Representative, Vontobel

**Chart 3: Joe Biden's and John F. Kennedy's approval rating: Could Biden's rating also benefit from rising external pressure?**

Months of respective President in Office (In %)



Source: Real Clear Politics, Vontobel

grants him more power, such as foreign policy and trade agreements. President Biden might want to focus on these areas rather than on domestic politics to showcase his (and the Democrats') ability to govern the country. This could affect the midterms' impact on geopolitics. Former US President John F. Kennedy, for example, profited substantially in opinion polls from his foreign policy stance during the Cuban Missile Crisis in 1962 (see chart 3).

#### **A divided government through a split Congress or a red sweep—what's the difference?**

There may not appear to be a significant difference between what to expect in a split-Congress scenario and a Republican-ruled Congress, where Republicans take not only the House but also the Senate. A split Congress would already make it more difficult for President Biden and the Democrats to get new laws passed, as discussed above.

Yet a red sweep would make it possible for the Republicans to not only block new fiscal legislation, as with a split Congress, but also to use a budget reconciliation process to pass fiscal legislation with deficit reduction laws. This would reduce fiscal spending and thus lower the growth impulse for the economy, which the Democrats would likely be able to prevent as long as they are in control of at least one of the chambers. During the next few years, major changes to fiscal policies are still unlikely even if the Republicans take both chambers: There is currently no major deadline for congressional action on taxes until 2025 and the probability that the Republicans could hold more than 59 seats in the Senate to overcome any filibuster tactics by the Democrats is very low.

But, as the Senate needs to approve any presidential nominations for judges presiding over district courts up to justices on the Supreme Court, as well as for cabinet officers or public ministers (such as ambassadors), a red sweep would make it significantly more difficult for President Biden and the Democrats to get these nominations through Congress. Hence, the political impact of a red sweep would be felt in the longer-term societal shifts brought about by the judicial processes and ways in which the Senate majority impacts the judges and public officers whose job it is to interpret laws and therefore define the "dos and don'ts" of society. Just one more seat gained by the Republicans would mean they would take control of the nominees the president presents—crucially,

that means appointments to the US Supreme Court. The Supreme Court's recent move to overturn *Roe v. Wade* underscores just how consequential judicial actions can be for society and its members. However, in regard to new nominations, now that Supreme Court Justice Stephen Breyer has retired, no upcoming change to the Supreme Court bench is visible in the near future.

#### **A blue sweep: Democrats take it all**

In the scenario of a blue sweep, the Democrats retain full control in both chambers, and the president can be more effective when it comes to pushing fiscal programs through Congress. If a recession were to be announced, targeted fiscal packages could pass with full support through a Democratic-ruled House and Senate. This would be a plus from a growth perspective if the US economy were to deteriorate quickly. In such a scenario, the unified control in Democratic hands would most likely lead to a faster and more comprehensive fiscal (and regulatory) reaction to support the economy. On the other hand, such fiscal programs would likely translate into increased public expenses and higher budget deficits. Sooner or later, such a policy will also result in higher taxes, as public debt will have to be either reduced again or, at minimum, kept in check.

Such an expansionary fiscal policy, particularly when implemented in a proactive way, would also conflict with the current restrictive monetary policy of the US central bank, which tries to dampen economic activity in a forceful attempt to reduce inflation levels last seen in the 1980s. Recent events in the UK, where contradicting fiscal and monetary policies led to negative market reactions, make it clear the potential risk fiscal and monetary uncertainty can pose for financial markets.

Having said that, a government under full Democratic control would allow the party's left-leaning bloc greater political power. It is expected that a unified Democratic government would increase the likelihood of more regulation in both the environmental and tech space. However, as it is unlikely that the Democrats will win more than nine additional Senate seats, they will not reach the 60-vote limit to pass a regulation without the consent of at least some Republican senators, which should also keep changes in check. Still, at the margin, a Democratic-controlled Senate would raise the odds of increased regulation.

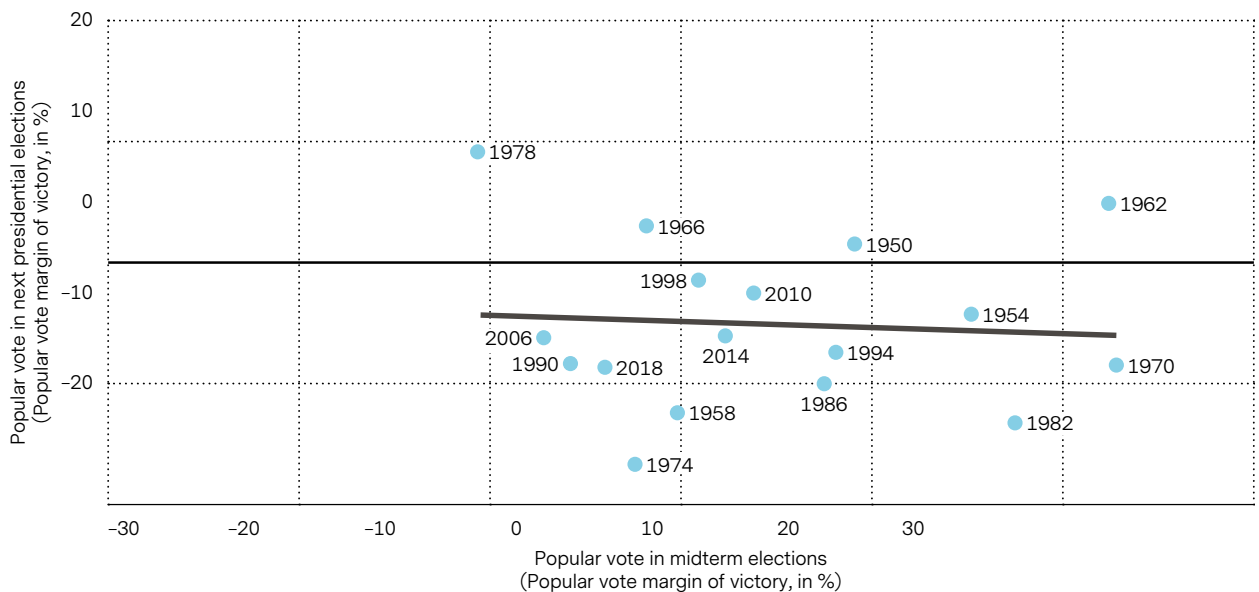
# Will the US midterm results shape the 2024 presidential elections?

Midterm election results are usually not a reliable way to predict the probability of a president being reelected in the next election. Both Bill Clinton and Barack Obama suffered heavy losses in the midterm elections but still managed to get reelected safely. Empirical evidence also shows that predictive power for the more fundamental popular vote—not the presidential election outcome itself, but which party gains the most individual votes—suggests that it is “normal” for serving presidents to lose some votes in the midterm elections but regain them when standing for their second-term presidential election. This information even hints at a negative correlation between popularity in the midterms and the presidential elections (see chart 4).

### What to watch

On the Republican side, pay attention to how candidates supported by Donald Trump will fare in the midterms, for both gubernatorial races and seats in Congress. The success of Trump-supported candidates in these midterms is expected to indicate the strength of his standing within the Republican party, and therefore his likelihood of being the Republican candidate for the next presidential election in 2024. If the Republicans are to take control of the House of Representatives during the midterms, one clear sign of Trump having a strong standing within the Republican party would include the resolution of the “January 6 Committee”, which is currently investigating Trump’s role in the attack on the US capitol days before President Biden’s inauguration on January 20, 2021.

**Chart 4: Statistically, midterm results have no predictive power on the following presidential election race**



Source: Federal Election Commission, Clerk of the House of Representative, Vontobel



When it comes to the Democrats, it will be interesting to see whether they can mobilize a high share of Hispanic voters in these midterms. This is key because Hispanic voters are widely considered to be an untapped electoral source for the Democrats. If President Biden succeeds in harnessing the support of Hispanic voters during November's midterms, the odds of him running again for the White House in 2024, with the full support of all wings of the Democratic party, will increase.

On a bipartisan note, there is a current congressional attempt to pass a bipartisan law to reform "The Election Count Act of 1887". If this succeeds before the next presidential election, it could help reduce the current political polarization in the US and relieve tensions around the integrity of the US electoral system among certain voting blocs. This could make it less likely that election disputes will get out of hand after the 2024 presidential election, an issue of concern following reactions to the 2020 election results, including the attack on the US capitol referred to above. This reform of the electoral law, initiated by the Democrats, would have a higher likelihood of passing Congress (all else equal) if the midterm elections resulted in a blue sweep or, at minimum, did not indicate strong support for Trump-backed Republican candidates.

#### **Biden v. Trump: the sequel in 2024?**

Many believe that Donald Trump has multiple incentives to run for president again. First, it would give him the chance to make up for his failure to secure a second term and hence distinguish himself from the only other presidents who failed to do so since 1933—Jimmy Carter, George H.W. Bush and Gerald Ford. Second, he might expect that his candidacy could provide him with a certain partial immunity regarding the various legal charges he currently faces, or at least ensure heightened caution in the handling of them. Third, he still receives more media attention than any other Republican in the front row.

If we were to see Trump running for president and winning the 2024 Republican nomination, the Democrats would have a strong incentive to select President Biden to run against him. Biden has already proven he can beat Trump once. However, this time around, Biden faces other issues: He's going to be 82 in 2024, and critics have not withheld from questioning whether his age is compatible with the demanding job of president. A split Congress would likely result in his ventures and initiatives being blocked, and this, together with his increasing age, could play into the hands of those wishing to paint him in a negative or ineffective light. However, President Biden's rebound in momentum has come to a halt lately, but securing Democratic control of the Senate could see it increase further as he would be able to be more active on the constitutional and judicial side, with voters' support for the Democrats having increased in the aftermath of the US Supreme Court's overturning of *Roe v Wade*. (See chart 3, Biden's approval rating)

There are many other potential candidates out there. Among the Democrats, there's Transportation Secretary Pete Buttigieg and Vice President Kamal Harris. It's also plausible that some Democratic presidential candidates may not be on the radar yet, just like Obama's star swiftly rose in the two-year period before the 2008 presidential elections. Among the Republicans, Ron de Santis, governor of Florida, stands out as "Trump Lite", as does Mike Pence, who served as Trump's vice president but would not be deterred from running against him as their relationship soured following Biden's 2020 win.

# How the US midterms will impact geopolitics, in light of the Chinese Communist Party Congress

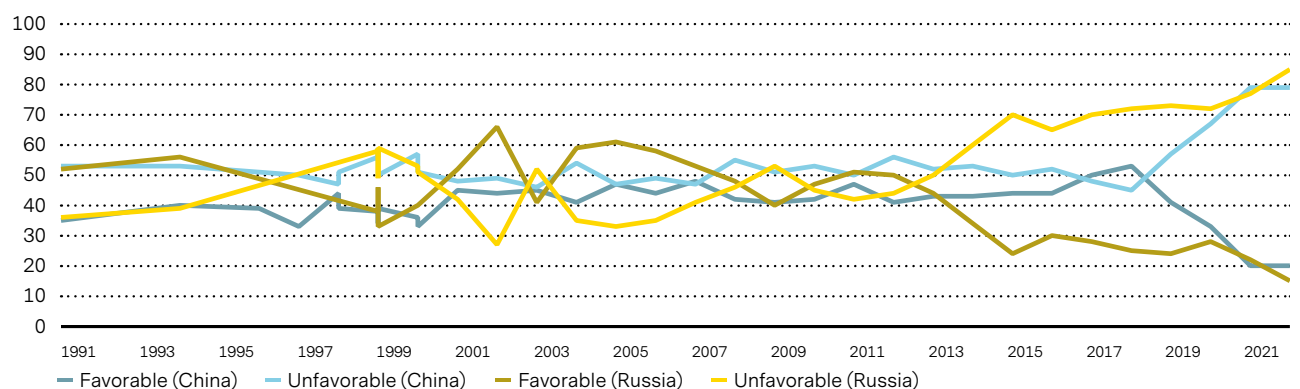
It's unlikely that there will be any significant changes to US foreign policy strategy after the midterms or the 2024 presidential elections. This is because US foreign policy places a large focus on China and Russia, countries toward which there is a strong bipartisan view, with voters from both parties regarding them as unfavorable. When it comes to both China and Russia, the opinions of US voters reflect a long-term trend that's unlikely to undergo any quick change. This apparently entrenched attitude among US voters is likely to keep the country's foreign policy toward China and Russia on its current path (see chart 5).

Looking at China specifically, the tense relationship between these two nations is not likely to improve. President Biden's rhetoric in favor of Taiwan's independence and the US representatives' visit to Taipei, Taiwan's capital, during the last quarter are contributing factors. Additionally, Biden has further tightened US exports of technology to China, thereby constraining its continued efforts toward modernization.

However, while views among US voters and representatives may not change, the individual who becomes president in 2024 could bring about a shift in political style for foreign policy. A Trump presidency (or a Trump-like president) could be a game changer—impacting the ways in which negotiations are handled between the US and other nations. Particularly when it comes to Russia – it is unclear how Trump or a Trump-like president would act if the current war between Russia and Ukraine continued. Trump was unable or not willing to secure strategic alliances with geopolitically important partners, such as the EU, nor did he cultivate new alliances during his term as president, unlike current President Biden, who has forged the Quadrilateral Security Dialogue (Quad) and AUKUS (Australia-UK-US). A second Trump presidential term would almost certainly result in more uncertainty about US foreign policy, at least initially, and if he withdraws the US from global leadership bodies and alliances, his reelection could create a vacuum for other global players with strong geopolitical ambitions, such as China and Russia. On this topic, it's important to note that during his

**Chart 5: Americans' views of China and Russia got more unfavorable on a bipartisan basis**

In % of total answers



Source: Gallup, Vontobel

first term, Trump threatened to withdraw from NATO and halted US funding for the World Health Organization at the height of the pandemic.

### **Will Xi's reelection result in changes to China's grand foreign policy strategy and its US relations?**

It is unlikely that any changes will be made to China's foreign policy following the reelection of Xi Jinping as head of the Chinese Communist Party, which took place on October 22. At the party congress, he reiterated the current principles of his party's policy, with his reelection speech emphasizing national security and defense issues even more so than his speech in 2017 did.<sup>1</sup> In addition, he reiterated the Communist Party's aim to "reunify" with Taiwan and that forceful reunification remains an option. It will be telling to observe China's reaction to the results of Taiwan's midterm elections, set for the end of November, as this will shed more light on the Chinese Communist Party's current view towards Taiwan.

Is there anything that could change the course Xi's government is currently charting? Over the next year or two, at the beginning of his new term, Xi seems to have a short-term incentive to bring growth back to better levels after economic activity deteriorated substantially over the last two quarters. If we see signs that Xi's government starts to increase fiscal and monetary policy stimulus further (translating into a central bank policy that supports more lending and thereby the real-state sector), induces deregulation of the tech sector, eases monetary and financial regulation, and ventures a cautious relaxing of the Covid Zero policy in order to boost growth, we might also see China's attempt to do so by improving ties with its most important trading partners outside the US, such as the EU, Japan and South Korea.

However, having said that, October's party congress indicates that the Communist Party places greater emphasis on security issues than on economic growth.<sup>2</sup> Also, financial markets made a clear verdict the day after the Communist Party Congress ended, as the stock index in Hong Kong fell more than 7% in the worst showing after any party congress since the index's inception in 1994 and foreigners sold a record net amount of 17.9 billion yuan.<sup>3</sup> It therefore seems wrong to expect a steady rapprochement between China and its geopolitical counterparts over the longer term. But this is not only due to Xi's prioritization—the government of China's most important trading partners have become more hesitant to foster ties with the Asian giant, as the statements of EU leaders at the latest European Council meeting made clear.<sup>4</sup> The bloc, which is China's second-largest trading partner after the ASEAN group of countries, is deliberating its dependence on China's economy, particularly in light of Europe's current struggle with Russian energy supply.

Taking a long-term view, in light of the recent Chinese Communist Party Congress, there seems to be no evidence that the current leadership in China would change its grand foreign policy strategy. With the information we have today, a change in the current course of Xi's government could most likely result from an extended period of substantially weak economic performance. The impetus for such a change would be the various forms of unrest and upheaval that such weak economic performance would trigger in both the population and the Communist Party. This situation could pave the way to a potential revision of the current strategy towards a more economic-friendly policy. But, given where things stand today, this seems quite an unlikely scenario due to the firm standing of Xi and his allies within China's power elite.

<sup>1</sup> See, for example, counts of key words in Xi's speech that provide evidence for such a shift in policy (Reuters: [reuters.com/world/china/chinas-xi-open-20th-communist-party-congress-2022-10-15/](https://www.reuters.com/world/china/chinas-xi-open-20th-communist-party-congress-2022-10-15/) or Politico: [politico.com/newsletters/politico-china-watcher/2022/10/20/xi-jinpings-20th-party-congress-victory-lap-bodes-ill-for-u-s-china-relations-00062578](https://www.politico.com/newsletters/politico-china-watcher/2022/10/20/xi-jinpings-20th-party-congress-victory-lap-bodes-ill-for-u-s-china-relations-00062578))

<sup>2</sup> Besides the counting of key words in Xi's speech, there is further evidence pointing towards a weaker future focus on economic development under Xi's government: According to the Financial Times, there were far fewer business people attending the Chinese Communist Party (CCP) Congress than on previous occasions (see: [ft.com/content/c6ea87de-8b25-43b3-bf9a-f59c1bd1e040](https://www.ft.com/content/c6ea87de-8b25-43b3-bf9a-f59c1bd1e040)). Another source of evidence stems from the fact that the changes in the most important body of the CCP, the Politburo Standing Committee, have favored close allies of Xi, all of whom have previously worked under Xi and which are not known for their commitment to focusing on economic development.

<sup>3</sup> See Bloomberg: [bloomberg.com/news/articles/2022-10-25/foreigners-flee-china-stocks-at-record-pace-as-panic-spreads#xj4y7vzkg](https://www.bloomberg.com/news/articles/2022-10-25/foreigners-flee-china-stocks-at-record-pace-as-panic-spreads#xj4y7vzkg)

<sup>4</sup> EU leaders deliberate future stance on relations to China in light of current energy crisis and in an attempt to reduce economic and political dependencies on other countries, see, for example, in Le Monde ([lemonde.fr/en/international/article/2022/10/21/eu-not-looking-for-systematic-confrontation-with-china\\_6001242\\_4.html](https://www.lemonde.fr/en/international/article/2022/10/21/eu-not-looking-for-systematic-confrontation-with-china_6001242_4.html)) or the invitation letter sent by the EU Council President pointing to the discussion ([consilium.europa.eu/en/press/press-releases/2022/10/18/invitation-letter-by-president-charles-michel-to-the-members-of-the-european-council-ahead-of-their-meeting-on-20-and-21-october-2022/](https://consilium.europa.eu/en/press/press-releases/2022/10/18/invitation-letter-by-president-charles-michel-to-the-members-of-the-european-council-ahead-of-their-meeting-on-20-and-21-october-2022/))

# What investors should pay attention to

If history is any guide, US stock markets usually perform quite positively in the quarter of and the two quarters following US midterm elections, although this should be taken with a pinch of salt as intra-year seasonality also plays a role here (see chart 6). However, this time, the economic and monetary policy factors seem to exert a much stronger influence than usual. It is widely expected that central bank tightening and elevated consumer prices will likely lead to meager growth in the US, if not to a recession in the quarters to come. So, the usual positive effects of the midterms (which relieve the markets from some uncertainty) might not be as influential on equities this time around.

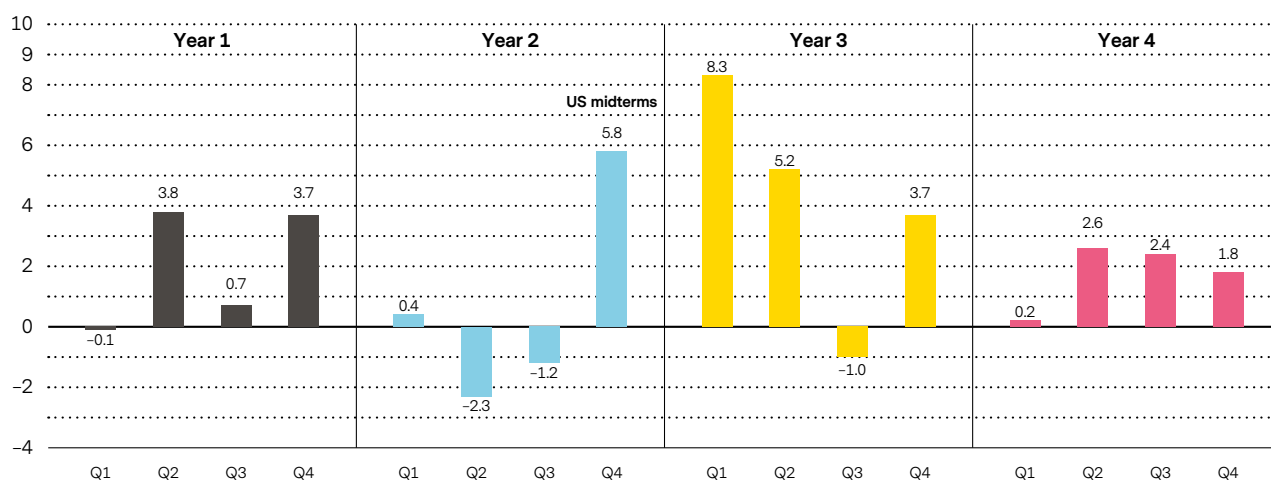
When could the results of the US midterm elections matter? If we do not see strong signals in favor of “Trump’s camp” from the Republican party nor experience a blue sweep in the upcoming US midterm elections, we don’t expect their results to influence financial markets markedly. This is because a divided government seems to be priced in already. However, if we experienced a blue sweep, the reaction of financial markets would depend substantially on whether investors are expecting an upcoming broad recession—that’s the big elephant in the

macroeconomic room. If investors are expecting an upcoming broad recession, then focus shifts to whether the government is able to dampen, either reactively or proactively, any stronger economic downturn. If a blue sweep were to take place under these conditions, the Democrats would have strong incentives to act proactively and comprehensively, as a recession is generally considered to be a bad harbinger for a party that wants to secure a second term for its president. On the other hand, if investors do not expect a significant recession, the midterms will likely have no meaningful impact on financial markets.

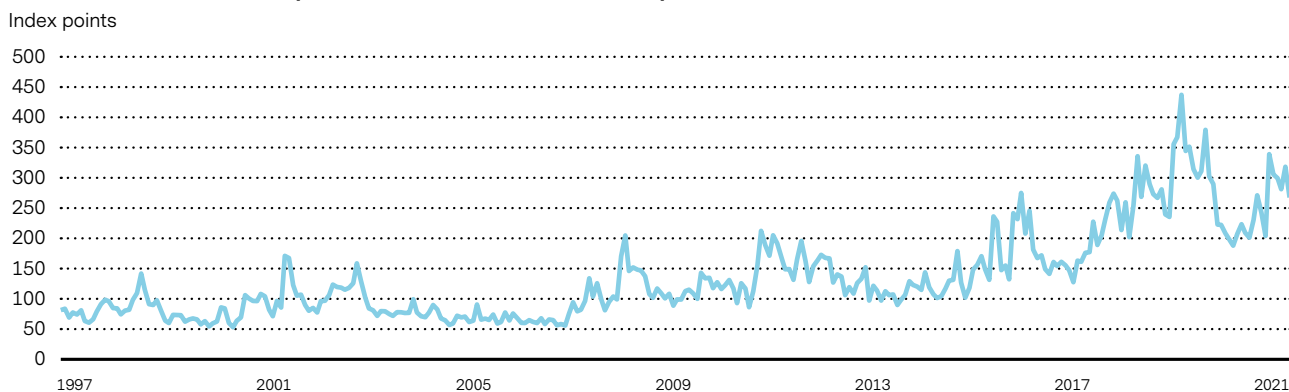
A blue sweep could even be seen as a negative sign because any proactive fiscal and regulatory support could conflict with the approach of the US central bank, which currently strongly restricts monetary policy in an attempt to reduce the decades-high inflation. The latest experience in the UK, with the clash of conflicting fiscal and monetary policies, makes clear that such a conflict would pose a risk for financial markets. Pressure could also be put on stock market sectors that the Democrats seem willing to regulate more, such as internet platforms and the energy industry.

**Chart 6: Midterms usually a good time to buy US equities**

Average quarterly return across the four year presidential cycles (1968 – 2020) in %



Source: Refinitiv Datastream, Clerk of the House of Representative, Vontobel

**Chart 7: Global economic policy uncertainty index trends upwards over the last 10 years**

Source: Refinitiv Datastream, Vontobel

If the midterms were to become a great success for the senators and governors Trump supports, this would be considered a strong indicator of a Trump presidential run in 2024. Such a scenario could increase the importance of the midterm results from a geopolitical perspective. This is because, as demonstrated during his first presidential term, when he threatened to withdraw the US from NATO, Trump is the potential candidate most likely to trigger increased uncertainty in foreign policy.

Finally, looking ahead to the presidential elections in 2024, if the abovementioned bipartisan attempt to reform the Electoral Count Act of 1887 is successful, this could be considered a positive sign from a bipartisan point of view. The reform would update law from 1887, addressing ambiguities on counting electoral votes and strengthening the electoral system before the next presidential election in 2024. Through clarifying the laws, electoral reform could help ease the social and political instability and polarization currently present in the US. Importantly, it would likely dissipate investors' fears regarding potential turbulence following the presidential elections.

#### **Geopolitical uncertainty likely to continue over the long term, following a short-term respite**

In terms of geopolitical uncertainty, what's the bottom line? Of course, currently, there are many conflicts that may prevent geopolitical uncertainty from waning in the short but also the long run, such as the ongoing war in Ukraine and the related shift in Europe's underlying secu-

rity architecture or the dispute around Iran's nuclear deal and its impact on the Middle East's future. But even if we block all other conflicts out to simplify the analysis, the power rivalry between the US and China is likely here to stay over the long run. As noted above, and despite Xi Jinping's speech at the recent Chinese Communist Party Congress outlining a long-term commitment to other goals like security, economic growth remains vital to securing domestic stability after the challenging years of the pandemic and weak growth figures during the last quarters. Hence, China's incentive to boost economic growth by improving ties with its most important trading partners (even including the US) might reduce uncertainty over the short term. But taking the latest developments in China and the possible scenarios we've detailed for the upcoming US elections into account, it seems unlikely that the current level of geopolitical uncertainty will be reduced by these players in the long run (see chart 7).

One probable result may be the formation of geopolitical blocs, with the US and China at the helm of the respective sides. One key element would be how the EU, as the third major global economic and political power, takes a stand regarding how this bloc would engage with China and the US in the future. We will observe the next moves from Brussels, Washington and Beijing closely but consider it unlikely that the current developments in China or the upcoming US midterms will alter the direction of the current geopolitical uncertainty over the long run.

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