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What a Divided Congress May Mean for Investors

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Key takeaways

» *Midterm election results were as expected, with Democrats retaking the House and Republicans maintaining control of the Senate.*

» *We believe a divided government should lessen the likelihood of market-impacting legislation.*

What it may mean for investors

» *We believe that investors should not rush to adjust portfolios based purely on election outcomes.*

» *We encourage investors to wait for legislative priorities to take shape and to refocus on positive U.S. economic fundamentals.*

The results are in

Last night, Democrats took control of the House of Representatives, while Republicans maintained control of the Senate. The Democrats appeared to take 230 seats in the 435-seat House of Representatives (218 seats are needed to control the House). However, the Republicans maintained 51 Senate seats securely—and were leading in four other still-undecided races in the predawn hours after the elections.

Potential policy and investment implications

In a divided government, both parties may attempt to drive policy direction. Yet, we believe that the chances of Congress passing significant, market-moving legislation are minimal. Democrats likely will focus on increasing oversight through their newly regained chair positions of House committees. They could use hearings and subpoenas of information from administration officials in an attempt to slow President Trump's agenda. The key components of the Republican agenda (e.g., tax reform and deregulation) should remain in place. Republicans should keep moving forward with further deregulation and continued appointments of cabinet positions and judges. Both of these areas generally do not involve House action; therefore, Democrats likely will remain limited in their ability to limit progress on these fronts.

It may be difficult for both parties to keep their campaign promises in a divided government. It will take time for progress to develop on many of these policies. Table 1 contains our best thoughts on areas in which we may see each party take action in a divided government.

Table 1: Potential areas of policy action and their market implications

Policy area	Likely implications
Taxes	• Republican tax reform should remain in place as it currently stands. • Democratic control of the House virtually eliminates chances of making the personal and pass-through tax cuts permanent. • Markets likely will be unmoved as the effects of tax cuts and higher deficits already have been incorporated.
Spending	• The expanded budget remains in place through fiscal year 2019. • An infrastructure spending bill could benefit the Industrials and Materials sectors. However, the parties take diverging views on infrastructure funding, and a deal is far from certain.
Regulations	• The Democrat-controlled House will be limited in its ability to slow the current Republican deregulation agenda. • Deregulation efforts should remain positive for business sentiment and economic growth.
Health Care	• Divided government likely means little further action to repeal the Affordable Care Act. • The White House may employ executive actions or regulatory reform, in order to control prescription drug prices. This is potentially negative for pharmaceutical and biotechnology companies.
Immigration	• After Congress failed to reach a bipartisan deal earlier this year, the prospects are low for a path to citizenship for Dreamers (those brought to the U.S. as children) in exchange for a wall on the southern border. • Democratic control of the House likely will eliminate chances of increased funding for border security.
Trade	• The ability to conduct trade policy is fairly self-contained within the executive branch, and Democrats likely will find that they have limited ability to modify President Trump's agenda. • The successful renegotiation of the North American Free Trade Agreement (NAFTA) into the U.S-Mexico-Canada Agreement (USMCA) likely will further President Trump's desire to redevelop global trade. • The U.S. also has announced intentions to begin negotiations with Japan, the European Union, and the United Kingdom. • Yet, we continue to expect that U.S.-China negotiations will take longer to resolve.

Source: Wells Fargo Investment Institute; November 7, 2018.

What may lie ahead?

With election uncertainty now out of the way, markets may return to focusing more on economic and earnings fundamental drivers. We believe the chances of significant legislation that has wide-ranging effects on the economy and markets (e.g., the Affordable Care Act or additional tax reform) are reduced under divided government. The question of whether Democrats in the House focus more on an investigative approach or work with Republicans to pass economically and market-beneficial legislation remains outstanding.

We change none of our investment recommendations—and do not favor rushing to adjust portfolios based purely on the election outcomes. The financial markets now have put behind them the uncertainty of the midterm elections, and the results are unlikely to deliver immediate and significant legislative changes. Fortunately, there is more clarity that the U.S. economy remains on solid footing and we believe should continue growing at a solid pace in 2019. We believe it is important for investors to maintain and follow their long-term investment plan. Opportunities may arise as signs of policy direction and priority materialize, and we will continue to provide timely guidance as these opportunities present themselves.

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