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PERSPECTIVES
VIEWPOINTS FROM THE ACADIAN TEAM

RAM THIRUKKONDA, CFA
VP, INVESTMENT STRATEGIST, CLIENT ADVISORY

QUICK TAKES ON THE MIDTERMS

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- **The U.S. midterm elections resulted in a consensus outcome that was largely expected in prediction markets.**
- **Nevertheless, much remains unclear in terms of potential policy shifts and their economic and market implications.**
- **The months ahead are likely to test the ability of the U.S. economy to generate and sustain growth in the face of receding stimulus from policy makers.**

Tuesday's elections brought neither a blue wave nor a red wave. As of early Wednesday, Republicans fortified their control of the Senate by a net gain of 2 seats, while Democrats had a net gain of 28 seats in the House of Representatives. This outcome itself was the modal or consensus outcome which, unlike the presidential election of 2016, betting markets correctly predicted. Hence, overnight reactions in various futures markets were not as dramatic as those from the 2016 election. Major equity markets were only modestly higher overnight by approximately +0.5% to +1% (< 1z) while in 2016 the same markets moved lower overnight by about -5% to -7% (roughly >4z event).

However, much remains unclear in terms of potential policy shifts and their implications for the economy and markets. Looking ahead, what are some of the issues that investors should consider?

Prior to the elections, my view was that the outcome of the midterms was unlikely to have a material impact on the economic cycle in the U.S. The Republican-led Senate and House have already passed a record tax-cut bill in 2017 under conditions of low unemployment. In the face of the resulting soaring deficits, it is not clear how much further fiscal stimulus is either possible or desirable. The administration has also largely pursued business-friendly policies, through nominees focused on deregulating finance, manufacturing, and mining. This represents an unwind of regulatory policies that had been tight since the global financial crisis of 2008. However, on the monetary front, the Fed has, thus far, independently pursued tightening in anticipation of higher inflation; although, this independence has recently come under pressure albeit of the rhetorical kind.

With split control, investors can expect that the House and Senate will have different near-term focuses. Headline risks, such as increased oversight in the form of an anti-corruption act or impeachment (although not conviction), increase with a Democrat-led House. This may also lead to "gridlock" on the policy front. However, there also appear to be areas in which the two parties can find common ground on select topics, such as prescription drug pricing reform or other aspects of healthcare, which is also widely recognized to have been an important issue to the electorate across party lines.

As well, policies pursued through executive actions, also likely unaffected by the outcome in the midterms, continue to have an impact on investor expectations. The threat of tariffs and an escalation in trade wars have contributed to a selloff in emerging market equities and raised larger questions about longer-term global trade balances. It is not clear that a split control between the House and Senate either ameliorates or exacerbates these concerns. While the House could pass legislation to limit executive actions, there is considerable uncertainty around the timeliness or broad support, even in the House, for such a response.

Let's consider election implications for asset markets in terms of three horizons. Given the consensus-expected outcome, the immediate reaction is likely a returning focus on fundamentals and the economy with a continuation of the prevailing short-term sentiment. Over the medium term between now and when the new congress takes office in 2019, investors are likely to learn more details and attempt to further price associated risks. My expectation is that information will be imprecise and incomplete, leading to speculation that may drive volatility and under/overreaction to headlines. That may create opportunities. Over the longer horizon, once the dust settles and the new congress assumes office in 2019, the same challenges from yesterday remain – sustaining economic growth in the face of tightening monetary policy with limits on new fiscal stimulus, increased resistance to deregulation, and broadly slower policy responses. Essentially, this amounts to a real test for the robustness of the U.S. economic expansion and whether it can finally carry the baton of growth absent direct stimulus from D.C.

BIOGRAPHY

RAM THIRUKKONDA, CFA

VICE PRESIDENT, INVESTMENT STRATEGIST, CLIENT ADVISORY

Ram joined Acadian in 2018 and is an investment strategist on the Client Advisory Team, aligned closely with Acadian's Global Client Group and Investment Teams. Prior to joining Acadian, Ram was a quantitative research analyst on the Asset Allocation team at GMO LLC, focused on portfolio construction, risk models, and signals. Ram also previously worked as a quantitative analyst at Batterymarch Financial Management, where he conducted research on quantitative equity portfolios. Ram holds an M.S. specializing in financial engineering from MIT; an M.S. in transportation engineering/operations research from MIT; and a B.Tech. in civil engineering from Indian Institute of Technology, India. He is a CFA charterholder and a member of CFA Society Boston.

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