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BREAKING NEWS
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# U.S. midterms produce divided government … and austerity?

*Votes are still being counted, but it appears the U.S. will be run by a divided government for the next two years. While such arrangements have, in the past, been associated with strong growth and positive market returns, they can also produce dysfunction.*

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## WHAT HAPPENED?

While the margin will likely be narrower than expected, it appears that Republicans will control a majority in the House of Representatives when the 118th Congress convenes in January. The Senate remains too early to call and could hinge on a runoff in Georgia, but the margin will be razor thin either way. So, just like his two immediate Democratic predecessors, President Biden faces an oppositional Congress in the second half of his term.

This outcome was widely expected, and market reaction thus far has been muted, at least by 2022 standards. We expect the factors that have influenced asset prices throughout the year – inflation, interest rates and recession risks – will continue to be the primary market drivers in 2023.

## DYSFUCNTION OR AUSTERITY?

Divided government is, of course, not new to U.S. politics or to global investors. We don't have to look back too far to find other examples of full or partial Republican control of Congress under a Democratic president. Presidents Clinton and Obama faced opposition during the majority of their presidencies. Yet the late 1990s and mid-2010s were marked by economic expansion and excellent returns on portfolios of diversified financial assets.

History tells us to expect few if any major pieces of legislation to arrive on the president's desk during the next two years. In place of lawmaking, we anticipate a generous serving of partisan gridlock punctuated by tense periods of brinksmanship on budget matters. This risk has become most acute when Congress is tasked with raising the U.S. debt ceiling.

Most notably, in August 2011, the U.S. credit rating was downgraded several days after the U.S. Treasury narrowly avoided a default when President Obama and Congress could not agree on a spending deal that included an increase in the debt ceiling. (The debt ceiling prevents the Treasury from borrowing above a certain amount to fund spending, even if that spending has already been approved by Congress and the president.)

This crisis, which occurred in the wake of the Great Recession and amid continued weakness in the global economy, rippled throughout financial markets over the remainder of the year. But the

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truly lasting effects of the 2011 debt ceiling crisis and the bipartisan negotiations that followed was a period of lower federal government spending growth and smaller budget deficits, often referred to as austerity. From 2011 to 2014, federal government spending and investment subtracted close to 0.25% from the U.S. GDP growth rate each quarter, on average. At its peak effect around the turn of the year from 2012 into 2013, the effect was close to three times that size.

## DON'T EXPECT MORE STIMULUS

Back in the mid-2010s, with the economy still crawling out of the hole of the Great Recession, austerity likely held back the recovery in unemployment and wages. In 2023, however, with employment close to full and inflation well above normal, shrinking budget deficits will likely manifest through lower inflation rather than lower real growth. The budget surplus in the late 1990s, under a similar political arrangement and amid robust economic and market growth, is remembered fondly for this reason.

We are somewhat more concerned about what response, if any, the federal government might have if the U.S. economy plunges into a severe recession. While this is not our base case, recent experience from 2020 suggests that a fast injection of stimulus can stabilize an economy, alleviate the effect of job loss and help set the stage for a faster recovery. But it is not clear to us that even passing a substantially smaller stimulus package than those that passed in 2020 and 2021 through a divided Congress would be an easy task.

## AN ACTIVE LAME DUCK SESSION AWAITS

The current Congress is still in session for just under two months and will have a full calendar of business before breaking for the holidays. Most pressing will be the passage of a budget for the 2023 fiscal year. As "must pass" items, budget agreements often have other bills attached to them to help ensure their passage. We see a better-than-even chance that SECURE 2.0, a bill with a myriad of provisions to help workers save more efficiently for their retirement, will be enacted as part of an omnibus bill before the end of the year.

While some Democrats favor raising the debt ceiling during the lame duck to prevent the type of crisis we described earlier from occurring in 2023, it seems unlikely that they will have enough support to do so.

## HERE COME THE PEN AND THE PHONE

Just because we don't expect a steady flow of major legislation over the next two years does not mean the policymaking wheels have stopped altogther. The Biden administration will likely turn to greater use of executive orders and regulatory policy – done through the bureaucracy – to accomplish what it can without going through Congress.

Most notably, we expect a series of new rules from the Securities and Exchange Commission and the Department of Labor on environmental, social and governance (ESG) metrics as they apply to public companies' reporting and the menus of investment options in retirement plans.

## AVOID INVESTING BASED ON POLITICS

We know from survey data, most infamously the University of Michigan Consumer Sentiment report, that the views of both Democrats and Republicans on the economy and their own personal financial situations can turn on a dime based on election results.

But we see little if any evidence that consumer behavior tracks consumer sentiment or that investors can reliably gain from timing markets based on the government's makeup. And because we expect little in the way of market-moving deals on taxes or new programs in the new Congress, we do not expect political developments to be consequential for investment returns. At least, not intentionally.

The bottom line is that market and economic fundamentals matter much more than the makeup of Washington, D.C., when it comes to investment success. As we write this, Nuveen's Global Investment Committee is convening for our year-ahead outlook meeting. We're spending much more time discussing interest rates, earnings, liquidity, valuations, client needs and portfolio construction themes than election results.

Stay tuned for our full readout on next year's opportunities in the coming weeks.

## For more information, please visit us at nuveen.com.

**Endnotes**

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