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US midterm elections in focus

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Guy Foster, Brewin Dolphin's Head of Research, explains why a divided government won't derail the US economic juggernaut.

For once, a political result came in much as had been expected. The US midterm elections saw Democrats take control of the House of Representatives but lose ground in the Senate. Given this took nobody by surprise, the market reaction was muted.

Our view is that with the elections now out of the way, investors can refocus on what really matters: the state of the US economy and Federal Reserve Policy.

Interest rates

All eyes will now turn to the latest policy statement from the Fed coming this Thursday. This is expected to indicate that US interest rates will rise in December.

What is less clear cut is when rates will move from a stimulant to a restraint. Bear markets are typically associated with global downturns, which themselves are usually the result of a US recession. A powerful catalyst for a recession would be interest rates moving into restrictive territory – where debt service costs move to such burdensome levels that they discourage spending and investment.

r*, or R-Star, is an increasingly used term amongst central bankers, referencing the 'neutral' level of interest rates for an economy. R-Star marks the theoretical point of 'crossover' between rates being stimulative to them being restrictive.

It is our assumption that R-Star is currently much higher in the US than previously anticipated. The reason for lower market estimations for R-Star reside in the elevated levels of debt in the economy relative to history. There is no doubting this fact and, therefore, it should carry significant weight in any assessment of R-Star. There are, however, plenty of reasons to believe the US can deal with higher interest rates, at least in the short term. This leaves the current US policy setting in 'generous' territory and the probability of a recession in the next 12 months as low.

Bolstering balance sheets

Chief among the reasons behind our assumption are the corporate and personal income tax cuts enacted by the Trump administration. These have served to bolster corporate and household cashflow and balance sheets.

We would also point to the shortfall in homes relative to population growth or, more strictly, household formation. Supply has never fully recovered since the global financial crisis but now, with the economy in much better condition, a meaningful acceleration in housing construction is a genuine possibility.

There are plenty of things to worry about in financial markets including trade wars, the Italian Budget, a Chinese slowdown and a dramatic showdown in both Westminster and Brussels.

Democratic control of the House also raises the spectre of US congressional gridlock over the next two years. However, potential obstruction on future policy is unlikely to worry the Trump camp or markets too much. Trump's market-moving domestic policy ambitions are largely complete, and his foreign policy agenda requires little congressional involvement.

Playing each scenario out to its logical conclusion, it seems none has a sufficiently high probability of derailing the US economic juggernaut; at least for now.

Dollar and debt

One consequence of an elevated expectation of where interest rates can go (or of a higher R-Star if you've been paying attention!) is that there could be more upside in the dollar. This is supportive for our overweight in US equities, where we have recently increased portfolio weightings.

Dollar strength is less helpful for emerging markets, many of which have hefty dollar debts which become more challenging to service. On that basis we trimmed emerging market exposure earlier this year.

Next year, debt, which has ballooned to nearly $21.7 trillion, could also become a bigger issue in the States. We expect markets to become more focused on the size of US budget and current deficits at some stage in 2019, calling an end to the dollar bull market. In turn, this should also herald a more favourable period for emerging markets, and we will look to make this trade as our thesis plays out.

However, for now, stock markets and particularly US equities remain the most appealing asset class; even more so given October's valuation adjustment.

Guy Foster, Head of Research

Guy leads Brewin Dolphin's Research team ensuring that a rigorous and exhaustive investment process is employed. He also provides recommendations on tactical investment strategy to Brewin Dolphin's investment managers and strategic recommendations to the group's Asset Allocation Committee. Before joining Brewin Dolphin in 2006, Guy was an Investment Director at Hill Martin (Asset Management). Guy has a Masters in Finance from London Business School. He is also a CFA charterholder, holds the CISI Diploma, and is a member of the Society of Business Economists. Guy frequently discusses financial issues with the written and televised media as well as presenting to the staff and clients of Brewin Dolphin.

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