

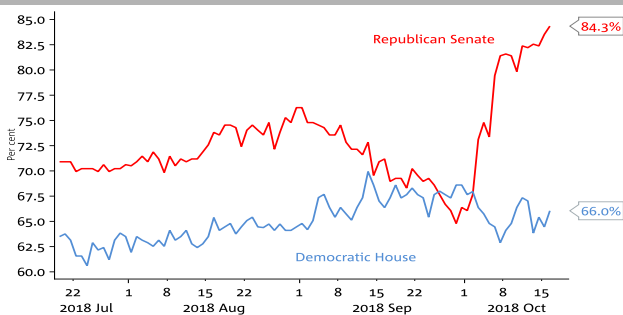


US mid-terms: why should we care?

- **Dems. winning House and Reps. holding Senate not a forgone conclusion and where AUD FX risk is highest**

November 6th sees the mid-term US elections, with all 435 seats in the House of Representatives up for grabs and 35 of the 100 Senate seats. Democrats need to gain 24 seats to win control of the House from Republicans, who currently have 235 seats. Democrats hold 193 while 7 are vacant. In the Senate, Republicans hold a 51 to 49 majority. Democrats have 47 seats but 2 independents caucus (side) with them. 26 of the 35 Senate seats up for re-election are held by Democrats, only 9 by Republicans. Since not all Dem. seats are 'safe', then together with the small number of Rep. seats being contested, odds of the Dems. taking the Senate appears low. Betting odds give Reps. an 84% chance of retaining the Senate and Dems. a 66% change of winning the House 66% (Chart 1).

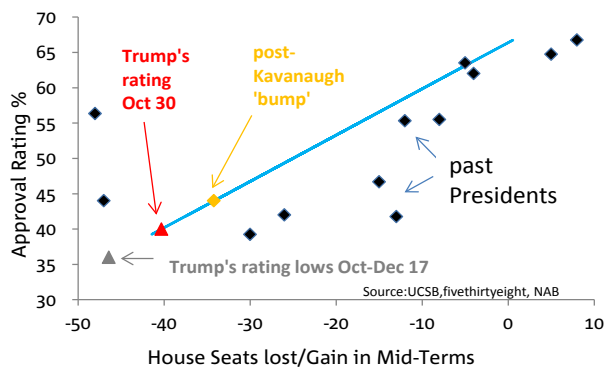
Chart 1: Betting Odds For Senate and House



Source: National Australia Bank, PredictIT

One reason for expecting Dems. to pick up enough seats to win the House is Trump's poll ratings and the historical tendency for the President's party to gain or lose seats depending on their popularity. Compared to the past 12 Presidencies, Trump's current approval rating is consistent with the loss of +/- 40 Rep. seats (Chart 2).

Chart 2: Presidential popularity and mid-term swings



Source: UCSB, fivethirtyeight, NAB

Partly because Trump's support base is stronger among older than younger voters and the historical tendency for more older voters to get out and vote in the mid-terms, we'd suggest the implied 66% probability of Democrats

winning the House might be a little generous to the Dems. We have no quibble with the bookies' odds of the Republicans retaining the Senate, putting it around 85% given the small number of Republican seats up for grabs. But Democrats winnings control of both houses is far from impossible if its supporters turn our en masse. Our assigned probabilities below assume Senate and House outcomes are independent (so don't sum to 100%).

What will the results mean For AUD?

(i) Dems. win House, Reps. hold Senate (65% chance)

'Legislative gridlock' is likely if the Republican lose the 'clean sweep' they won in 2016 (Congress and the White House). The House will be able to block Republican attempts to both extend and make permanent tax cuts (Trump has lately talked of a 10% middle-class tax cut and previously of indexing capital gains for tax purposes) as well as attempts to reduce social security spending.

On the flip side, the Senate would block any efforts by the House to roll back some of this year's tax cuts. Renewed attempts by Republicans to overhaul Obamacare should get nowhere. There could be bipartisan agreement for an infrastructure package but only if this isn't tied to funding for 'the wall'. There is a risk here of a Trump-instigated government shutdown, which could aggravate 'risk-off sentiment' and in doing so hurt the risk-sensitive AUD.

In general though, this outcome **shouldn't have major implications for the AUD**, though bear in mind the White House can go hard on trade and foreign policy without reference to Congress – which we expect and which limits prospects for an early recovery in the AUD.

(ii) Reps. retain both House and Senate (35% chance)

Markets will need to factor in additional fiscal policy easing from the tax side, though potentially also offset from social spending/healthcare reform. Probably good for stocks but also higher rates (and with that weaker stocks down the line). **This is a likely initially USD positive and hence AUD negative outcome.** Further out, heightened prospects of a two-term Trump Presidency might undermine confidence in US assets and the USD – but a story for 2019 not 2018. It will ratchet up concerns Trump's tirades against the Fed will move to a new level with some attempt to crimp the Fed's powers.

(iii) Dems. win the House and Senate (10% chance)

Even bigger gridlock with likely Presidential veto of Congressional legislation. Raises Trump impeachment risk but chances of conviction are very low, requiring a 2/3rds Senate majority. Trump can still pursue his hawkish trade/foreign policy agenda (risk and AUD negative, but largely priced), while Government shutdown risk is higher. As a reflection of waning support for Trump, correlations suggest **USD negative fallout, so AUD positive, at least initially.**

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