Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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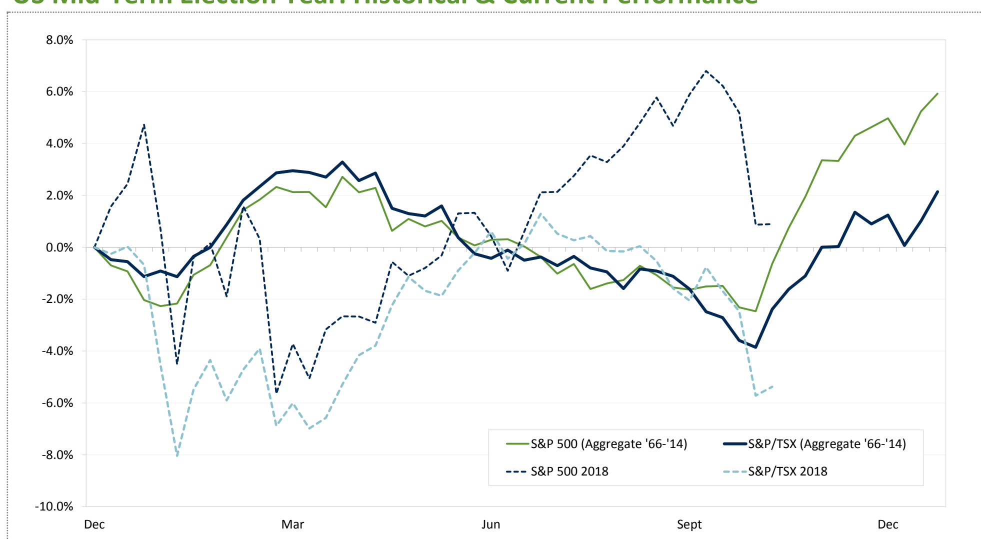
US Mid-terms

US mid-term elections will draw to a close this month and the party to control the House of Representatives and, to a lesser degree, the Senate will be known. The mid-terms can have a significant impact on the political landscape and this year will be no different as the American public will either hand Trump another two years to implement his election promises or place a cap on his political aspirations. From a market perspective, regardless of the party in power, the general trading pattern during mid-term years has been a choppy one, followed by a year-end rally to new highs. However, mid-term election years have a reputation for being the worst of the four-year presidential election cycle. Since 1872, the average return for the S&P 500 during the mid-term years is +4.1%, below the average for the remaining three years of the presidential cycle.

One of the reasons for the weaker performance is that the government tends to remove stimulus during mid-term years; however, this year is unique as we have seen a combination of both easing and tightening. Fiscal stimulus via the US Tax Cuts and Jobs Act took effect in January, while the Federal Reserve has been draining liquidity from the system by raising rates and normalizing its balance sheet. Historically, stocks tend to feel the effects of this tightening well into the mid-term year and this certainly is one of the issues the market is attempting to gauge going forward. With inflation measures at the Fed's target and solid employment trends, Fed Chair Powell may feel compelled to accelerate the tightening cycle over the coming quarters. The case for a more aggressive stance on rates may be cemented if the US government follows its typical pre-election pattern (in 2019) of pumping stimulus back into the economy ahead of the election year.

US Mid-Term Election Year: Historical & Current Performance



Source: Bloomberg, Raymond James Ltd.

Please read domestic and foreign disclosure/risk information beginning on page 8.

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One contributing factor to the recent bout of market volatility is the potential for the House of Representatives to flip (Republican to Democrat), which historically has not been a good outcome for the markets. The combination of a Republican President, Democrat controlled House and Republican Senate has produced below average returns for the market, but there have been very few instances of this combination occurring.

Average Returns Under Different Combinations

Yearly Returns Combination (Pres/House/Senate)	Average %	Count
DDD	9.3%	34
DRD	13.6%	4
DRR	13.3%	9
RDD	7.1%	20
RDR	3.7%	8
RRD	-18.2%	2
RRR	1.4%	12

Source: Bloomberg. Raymond James Ltd.

As of the publishing of this report, the outlook favours the House, but not the Senate, moving to the Democrats in November. Earlier in the year, there had been speculation that the Republicans would lose control of the Senate, which they have held since 2015. Despite needing to gain only two more seats for a majority, current polling shows the chances of a Democratic Senate appear remote. This is because, of the 35 seats to be contested in November, 26 are already held by Democrats. Only six races are expected to be close and again the Democrats are more at risk than the Republicans. In fact, 10 of the Democrat Senate seats up for election are in states that voted for Trump in the 2016 election. Current polls suggest there is a greater chance of the Republicans picking up 1-2 Senate seats than the Democrats retaking the majority.

The House race, however, is more in favour of the Democrats. All 435 House seats are up for election in November, but only 48 seats are expected to be competitive. The numbers show a distinct advantage for Democrats as 41 seats are currently held by Republicans and 25 of those districts voted for Hilary Clinton on the 2016 Presidential ballot. Two other predictive factors that favour Democrats are generic ballot polls that have consistently favoured the Democrats throughout the year (current average of 10 national polls shows 41.7-50.0% with 8.3% undecided, according to ABC News), as well as a relatively low approval rating for President Trump (current approval rating of 42.8%).

The Democrats need to maintain their current seats and flip 24 Republican districts to gain a majority in the House. This may seem like a high number, but it is actually quite manageable based on history. Since the 1994 election, the House has shifted from one party to the other on three different occasions with seat swings of 54 (1994), 32 (2006), and 64 (2010). Grabbing 25 seats when there is an unpopular President in the White House is a reasonable possibility, and current polling predicts the Democrats will flip the House with gains in the 30-35 seat range. The margin of victory has been shrinking in recent weeks, but still firmly favours Democrats; as of late October, ABC News gave a Democrat House win an 80.2% chance.

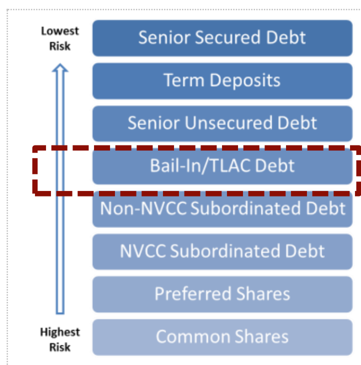
If the Democrats are successful in flipping the House, we can expect more volatility than ever in US politics. A House win would give Democrats subpoena power and we could see a number of high profile investigations reappear in the headlines, from Russian collusion, to Trump business ties and other scandals. Impeachment is probably off the table with a Republican Senate, but the spectacle of the Justice Kavanagh hearings could foreshadow the 2019 docket for the House Oversight, Judicial and Intelligence committees. A Democratic House could also slow the rate of deregulation coming from the White House, but will have little chance of passing any major left-leaning bills as the President maintains the power of the veto and will likely be happy to use it. Government shutdowns could return after a two year reprieve following the Obama years.

From a market perspective, there will be a lot to digest after the election. The positive impacts of tax reform will continue into 2019, but further stimulus to the US economy (a middle class tax cut and major infrastructure investment) could be much harder to come by under a split government. Corporate earnings should continue to remain strong with robust demand and relatively low inflation. In all, we expect the days leading up to and after the US election to be dramatic, but when the dust settles, traditional financial fundamentals will continue to be the key drivers of the markets. At this point in time, those indicators point to a continuation of the current bull market, regardless of which party gains power of the House or Senate.

Jason Castelli, CFA; Robert Mark, CFA

TLAC and Canadian Bail-In Regime

A new type of debt will be issued in the Canadian Bond market, Offered by the major Canadian banks which have been deemed Systematically Important Banks (SIB) by the Government of Canada through the Office of the Superintendent of Financial Institutions (OSFI).



These new bail-in bonds will be rated by the major rating agencies including: DBRS, S&P, Moody's and Fitch. They are expected to be one notch lower in credit than existing Senior Unsecured Debt.

What Are Bail-In Bonds?

- All unsecured senior bonds with an initial term of 400 days or greater that are not derivatives or structured products, and that have CUSIP/ISINs will be eligible to be Bail-In bonds.
- The credit rating for these instruments will be lower, based on a higher probability of default, which is viewed as conversion.
- The Bail-In regime applies to the six largest banks in Canada: TD, RBC, CIBC, Scotiabank, National Bank of Canada and BMO.
- The "new normal" for issuance in Canada of Senior Unsecured Debt will have a Bail-in or Total Loss Absorbing Capacity (TLAC) clause attached if the unsecured senior debt is 400 days to maturity or longer.
- These unique bonds could be converted into equity shares of the corresponding issuer of the bond investment.

Exclusions from Bail-In Debt

- Legacy unsecured debt instruments issued prior to September 23, 2018.
- Instruments with an original term of less than 400 days.
- Deposits, covered bonds, derivatives, structured notes and secured instruments.
- The new regime will not apply to funding issues by regional banks and, as such, they will be able to continue issuing deposit notes.

Why is Bail-In Debt being Issued?

During the recent financial crisis, the balance sheets of several non-Canadian banks became severely distressed, requiring bailout funds from their governments. As a result, the banks' subordinated debt holders were not affected.

The aftermath of the bank bailouts gave way to the era of Non-Viability Contingent Capital (NVCC). Starting in January 2013, most bank debt was issued as NVCC, allowing it to be used as capital if the OSFI deemed a bank to be at a point of "Non-viability", instead of the government providing capital injections.

How Would This Work in the Real World?

Unlike convertible bonds, where the investor has the power of choosing whether or not to convert the bonds into equity, these bail-in bonds would be converted based on decisions by OFSI. "The new normal" for bank bonds in Canada began on September 23rd, 2018, and they are to be issued as "Bail-In-Bonds". This means that in the event OSFI determines that a Canadian Systematically Important Bank (SIB) has become or is about to become non-viable, the Governor in Council can direct the CDIC to convert all or a portion of certain shares and debt into common shares to be used as capital if all NVCC securities are insufficient to cover this.

Unlike convertible bonds which have a fixed multiplier rate attached to the bond investment, bail-in bonds would be converted into equity shares at a rate determined by the CDIC. When the bond is converted, the capital structure of the bank will be considered and the bondholders best interests will be at the top of the agenda.

Additional Details

It should be noted that such a scenario is highly unlikely because these have been deemed SIB and are well capitalized financial institutions. In addition, these banks have a global presence and they want to protect their brands by ensuring that there are no capital failures within their respected organizations.

The TLAC (Total Loss Absorbing Capacity) framework ensures that Global Systematically Important Banks (GSIB) have sufficient loss-absorbing capacity to right-size their balance sheets by recapitalizing in the event of a failure. The banks are required to issue Bail-In Debt in order to meet standards set out by the TLAC.

Harvey Libby
Fixed Income

The Potential for a USD Sell-Off in the Event of a Split US Congress

The USD has put up an impressive performance this year, with the US Dollar Index (DXY) up nearly 5% YTD. US equities have also largely outperformed the rest of the world, which has attracted global cash to the US dollar. However, with the US midterm elections just around the corner, many analysts are anticipating that the USD rally is set to release additional steam after already having cooled down slightly as H2/2018 got underway

DXY

Source: Bloomberg, Raymond James Ltd.

The United States Congress is currently comprised of a Republican majority Senate (51 Republicans vs. 47 Democrats, with 2 Independents caucusing with the Democrats) and a Republican majority House of Representatives (235 Republicans vs. 193 Democrats, and 7 vacant seats). It is no surprise that the USD has received a material lift since President Trump was elected as he kicked off his presidency with a colossal +$4trln spending package and sweeping tax cuts, which were arguably his most significant policy achievements to date. By slashing regulatory hurdles, lowering corporate tax rates and taking an "America-first" approach to trade, US markets have surely enjoyed the ride, taking the USD higher in the process. However, the nonpartisan Congressional Budget Office (CBO), which is tasked with studying the fiscal fallout from such legislation, has shown that Trump's tax cuts will expand the federal deficit to $804bln in FY2018, up from $665bln in FY2017. Another striking statistic from the CBO's report was that the national debt is currently on track to approach 100% of GDP by 2028. As Trump effortlessly pushed through his budget proposal and tax cuts bill, with little-to-no push back from his Republican-controlled Congress, the key concern is how the US will cope with running record deficits while the Fed continues on its path of raising interest rates. The primary fear is that, should the need arise, the US would have little room to further increase spending in order to mitigate an economic downturn.

History has shown that the President's party normally loses congressional seats in mid-term elections. It is widely expected that the US government is headed back into deadlock with the Democrats projected to retake control of the House of Representatives while the Republicans continue to hold onto their majority in the Senate, albeit by a slim margin after potentially losing some seats. Such an outcome will surely throw a wrench into the stellar performance of US-denominated assets and the US dollar as investors begin to question the outlook for the US economy with President Trump at the helm of a divided Congress.

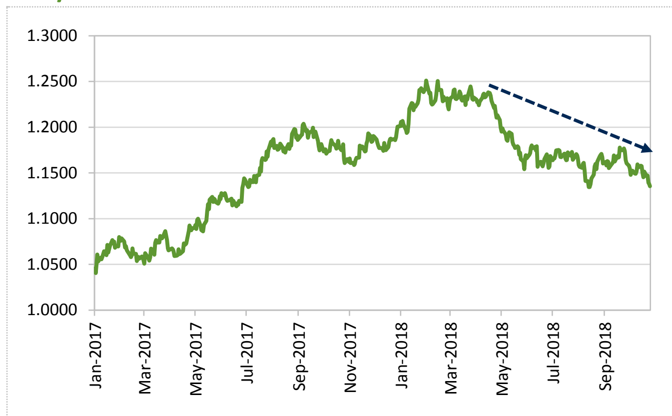
Following through with this baseline scenario of a Democratic House and a Republican Senate, a potentially divided Congress will undoubtedly have negative ramifications for the USD as it will mean a low likelihood of Trump's infrastructure plan, additional tax policy changes (coined "Tax Cuts 2.0") and trade policies getting the required Congressional votes. With Democrats likely to lean away from Trump's "America-first" position and side with US allies on trade, there is the potential risk of Democrats holding up approval for the recently-agreed upon NAFTA replacement (the USMCA), as they may very well push for changes to the agreement.

On the monetary policy front, Fed officials cemented expectations for a 4th rate hike before year-end and reaffirmed that a strong US economy will likely warrant further gradual rate increases as we head into 2019. However, the accompanying statement from the Fed's previous policy meeting saw it drop its long-standing description of monetary policy being "Accommodative," pushing many to believe that the Fed is approaching its neutral target and is nearing the end of its hiking cycle. Fed officials also voiced their skepticism that Trump's tax cuts would continue to provide a lift to economic growth in the long-term, stating that growth would eventually slow to 1.8% by 2021. This implies that should a deadlocked Congress halt Trump's expansionary fiscal policies, which in turn would likely lift the gas pedal off of a hot US economy and result in the Fed slowing down its pace of rate increases, the USD would be vulnerable to downside pressure.

Another important factor to consider in this debate of whether the USD rally days may be numbered is how the EUR performs going forward. Considered the US dollar's most important rival as it holds a 57.6% weight in the DXY, the EUR has been trading largely on the defensive with the EURUSD pair down nearly 6% YTD as the ECB continues to maintain its position of not raising rates, at least until the summer of

2019. With local political risks clearly elevated, namely over Italy's budget plans and ongoing Brexit uncertainties, the USD has received an added lift. Should these issues be resolved in the coming months and the ECB sticks with its plans to end its monetary stimulus program by December in the midst of Draghi's continued confidence in the economic backdrop of the euro zone, we believe the EUR is well positioned to rally higher, which would obviously come at the expense of the USD.

EUR/USD



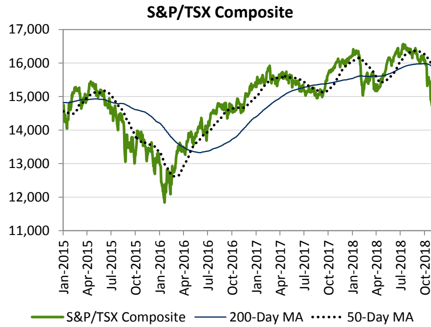
Source: Bloomberg, Raymond James Ltd.

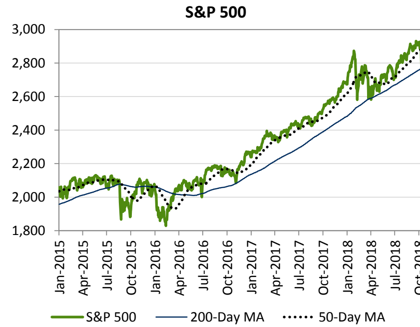
In the end, a split Congress along with the potential for EUR strength picking up in 2019 should set the stage for a USD sell-off, as expectations will call for yields to move slightly lower and markets to trade with a modest risk-off mood. On the other end, should Republicans maintain their control of both chambers of Congress, we can expect markets to continue trading in a risk-on fashion, yields will increase on the back of additional spending plans from the Trump administration, and the USD will continue to trade higher against its G10 peers.

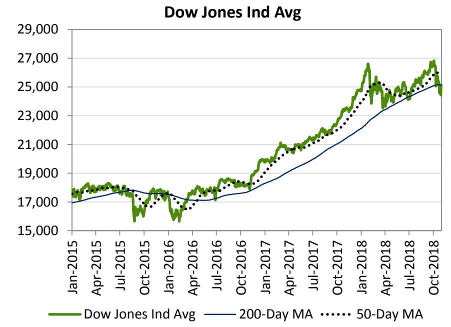
Ajay Virk, CFA
Foreign Exchange

Charts of Interest

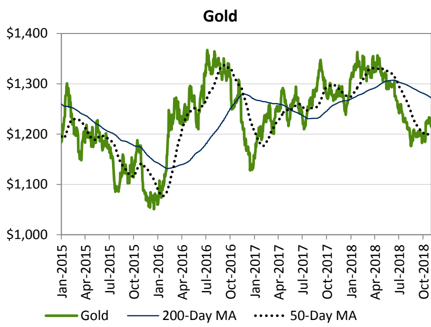
Markets

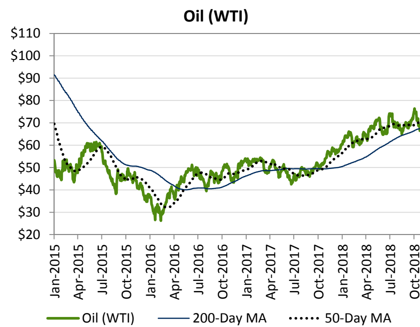


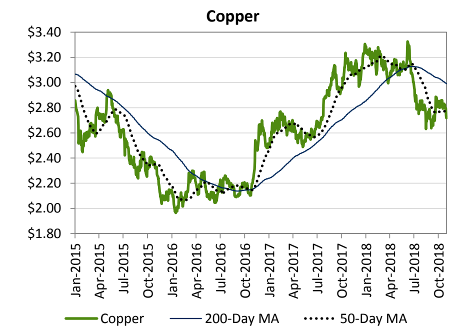




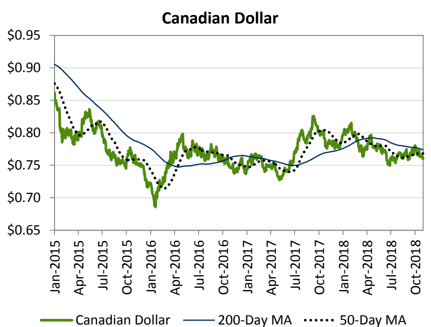
Commodities

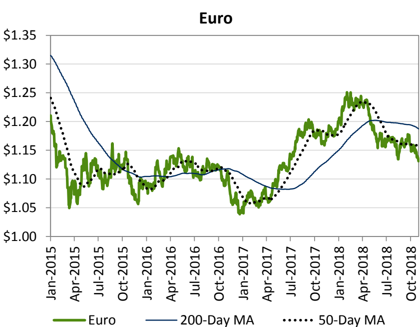


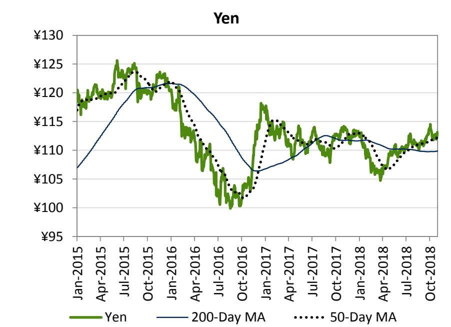




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at October 31, 2018.

Investor Profiles and Asset Class Weightings

Recommended Asset Allocation					
	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	5%	5%	5%	5%	5%
Bonds	72%	62%	37%	17%	2%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100
Description					
	May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

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