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What to Expect from Divided Government: Split Congress May Limit Fiscal Policy, Could Be Good for Markets

By Libby Cantrill, CFA®

INVESTMENTS & WEALTH INSTITUTE®

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Republicans have retaken the U.S. House of Representatives and Democrats have retained the U.S. Senate, so the next two years likely will feature legislative gridlock in Washington.

Each party, however, has just a razor-thin majority in only one chamber of Congress. This leads to another takeaway: The "red wave" that many pundits predicted never materialized. It was instead a—choose your metaphor—"red raindrop," "red ripple," or "red whisper."

Regardless, we believe the practical implications for the markets and the economy would be largely the same whether Republicans won the House only or both the House and the Senate. After all, the levers available to the party not in the White House—namely, obstruction and oversight—are now accessible to House Republicans regardless of their scant majority.

WHAT TO EXPECT FROM A SPLIT CONGRESS IN 2023

So, what does a split Congress mean for economic policy? We see four main implications:

A freeze on President Joe Biden's legislative agenda. Perhaps most importantly for markets, this means that all tax increases have been taken off the table—whether on the personal side, e.g., capital gains increases, or the corporate side, e.g., a windfall tax. This also suggests that the next inflection point for taxes will be 2025 when the Trump tax cuts are set to expire.

More oversight. House Republicans will flex their oversight powers on issues including the Biden administration's energy policy, its approach on China (which some consider insufficiently hawkish), and the Securities and Exchange Commission's panoply of proposed regulations. Oversight is likely to be more symbolic than substantive; after all, without veto-proof control of both chambers of Congress, Republicans can do little to alter policy. However, increased oversight can slow the regulatory gears and make it harder for any White House to advance policy. The Federal Reserve is also likely to be an object of oversight, but we doubt the Fed will be sensitive to any political pressure to change its focus on combatting inflation.

More fiscal fighting. This is where the House Republicans' slim majority may become a source of market volatility. Working with such a tight margin, House Speaker Kevin McCarthy (R-CA) will find it difficult to navigate upcoming fiscal inflection points. One tough spot in particular will be raising the debt ceiling, given that some in the Republican caucus indicate they will not support any debt limit increase without commensurate spending cuts, a non-starter for the Democratic Senate and White House. Despite the expected brinkmanship and potential for associated volatility, especially at the front of the yield curve, we believe that House Republicans ultimately will blink and the debt ceiling will be raised. Keep in mind that the 2024 presidential campaign will be in full swing, and it is unlikely Republicans will sacrifice their chance at the White House.

Less fiscal support. We believe bipartisan support will continue for ongoing aid to Ukraine and the defense budget, but we also believe there will be a higher threshold to providing broader countercyclical fiscal support, even if the economy slows. The U.S. economy experienced significant fiscal contraction in 2022 by virtue of many COVID-related programs rolling off, and in 2023 we can expect more contraction, which a split Congress is unlikely to do anything about. In other words, similar to the "Fed put" having been taken off the table, the "fiscal put" also has been effectively eliminated—at least until a new Congress comes into power in 2025.[1]

ROOM FOR COMPROMISE

Although our expectation is largely for gridlock in the 118th Congress, we do foresee some areas of potential compromise. These include legislation that could bring better clarity to the regulatory remit on cryptocurrencies—a need that is even more urgent given recent crypto exchange issues—and energy-permitting language that could expedite both traditional and renewable energy projects.

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WILL MARKETS LIKE THE ELECTION RESULTS?

Although past is certainly not prologue, equity markets historically have tended to do well in years of split government. Indeed, in previous years of a similar composition of power in Washington—namely, a Republican House, Democratic Senate, and Democratic White House—the equity market has returned on average 13.6 percent (per S&P 500 data), a higher average return than for almost any other composition of power. Of course, 2023 may look quite different from history given sticky inflation, recession risk, and war in Ukraine.[2]

A QUICK PIVOT TO 2024

Although speculation is rampant about who other than Donald Trump may be running for the White House in 2024, we would caution against extrapolating any conclusive outcomes this early in the cycle. Indeed, we likely are in for a number of twists and turns, which once again may surprise pundits and defy history.

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ENDNOTES

1. The term "Fed put," a play on the option term "put," is the market belief that the Fed would step in and implement policies to limit the stock market's decline beyond a certain threshold.
2. For PIMCO's detailed views on equities and other asset classes in the coming year, read its latest Asset Allocation Outlook: https://www.pimco.com/en-us/insights/economic-and-market-commentary/global-markets/asset-allocation-outlook/risk-off-yield-on.

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