

America's High-Stake Midterm Elections

The stakes in the upcoming congressional midterm elections (November 6) are particularly high. The Republicans currently control both the House and the Senate. Not only would the loss of one or both chambers of Congress bring Trump's agenda to a skidding halt, it could even signal the beginning of impeachment proceedings against him.

The 2018 midterms can also be divided into two separate elections. The Democrats are favoured to regain control of the House on account of Republican vulnerability in numerous suburban areas, whereas the Republicans look set to retain control of the Senate as the outcome there hinges more on rural states where Trump still has strong support. In all, 435 seats in the House of Representatives and 35 of the 100 seats in the Senate will be up for grabs in November 2018.

Historically, the incumbent president's party has not fared well in midterm elections. It has lost seats in the House in 9 of the last 10 elections held halfway through the president's first term. In the Senate, it has managed somewhat better. The sitting president's party has given up seats in only 6 of those 10 elections. Historically, supporters of the party not in power have tended to be more motivated to show up at the polls.

House of Representatives

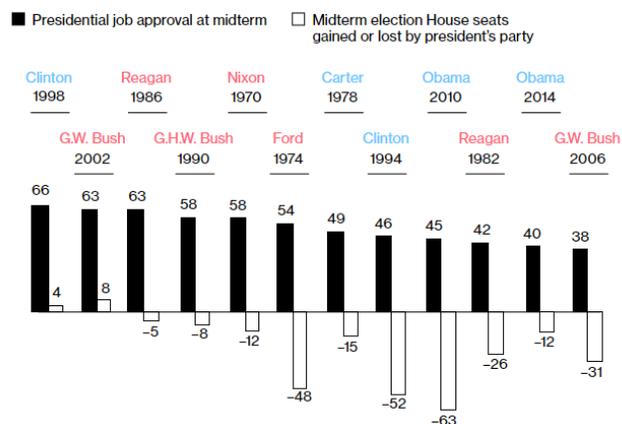
Republicans currently hold a 237-to-193 seat majority (with 5 vacancies) in the House of Representatives. For the Democrats to seize control of the House, they would have to gain 24 seats. Their greatest hope for gains lies in the 23 Republican-controlled districts won by Hillary Clinton in the last presidential election.

In the midterm elections from 1934 to 2014, the president's party lost an average 27 House seats, and 25 in the first term.¹ In the post-war era, the president's party has gained midterm seats only twice: in 1998 under Bill Clinton (5 seats) and in 2002 under George W. Bush (2 seats). It is generally believed Clinton got a bump in the polls because of public disapproval of him being targeted for impeachment, while Bush benefited from a rally-around-the-flag moment following 9/11.

Historically, the president's approval rating has been a more reliable indicator of the outcome of the midterm elections than has been the state of the economy. President Trump's average approval rating is currently hovering in the 41% range. (Some argue this figure does not take into account people who refuse to admit they are Trump supporters.)

President's Midterm Party Losses

According to Gallup, President Trump's job approval stood at 41% on Sept. 2



Sources: Gallup, American Presidency Project, Bloomberg research

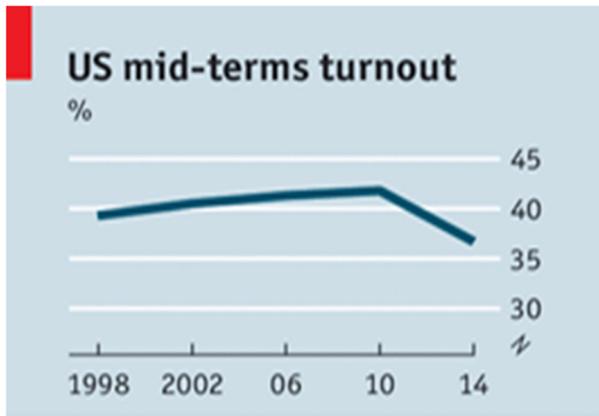
Source: "GOP Braces for Democratic Surge in November," Bloomberg, September 6, 2018

¹ "Republicans will need more than the economy to hold the House," The Hill, September 1, 2018

But Republicans have important structural advantages

Voter turnout

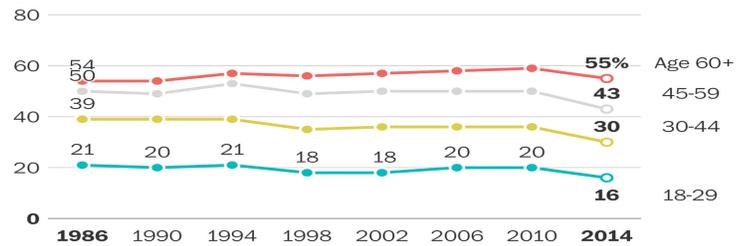
Historically, the relatively low voter turnout in the midterms has favoured the Republicans. This is because younger people, who make up a large part of the Democratic base, tend to vote at lower levels than do older white voters, who tend to favour the Republicans. In 2014, voter participation in the midterms was 37% compared with 55% in the last presidential election.



The Economist

Under 1 out of 6 Americans under age 30 voted in 2014, will 2018 be different?

Percent turnout among eligible voters in midterm congressional (non-presidential year) elections



Source: United States Elections Project analysis of U.S. Census Bureau data

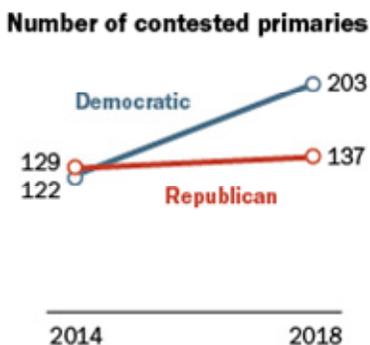
EMILY GUSKIN/THE WASHINGTON POST

Sources: “Many American states are making voting harder,” The Economist, August 11, 2018, and “Are young voters going to sway the midterms?” Washington Post, August 1, 2018

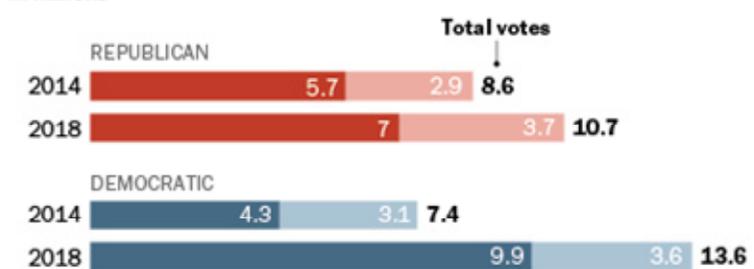
The Democrats are hoping that disapproval of President Trump will motivate millennial voters and other Democratic supporters to show up at the polls in greater numbers. So far, based on the total number of votes cast in the primaries (where candidates are selected for the general election), the Democratic base appears far more enthusiastic about voting than their Republican counterparts do.

More contested House races are driving higher turnout, particularly among Democrats

Among the 31 states that held their primaries by June 30 of each year



Number of votes in contested and uncontested primaries



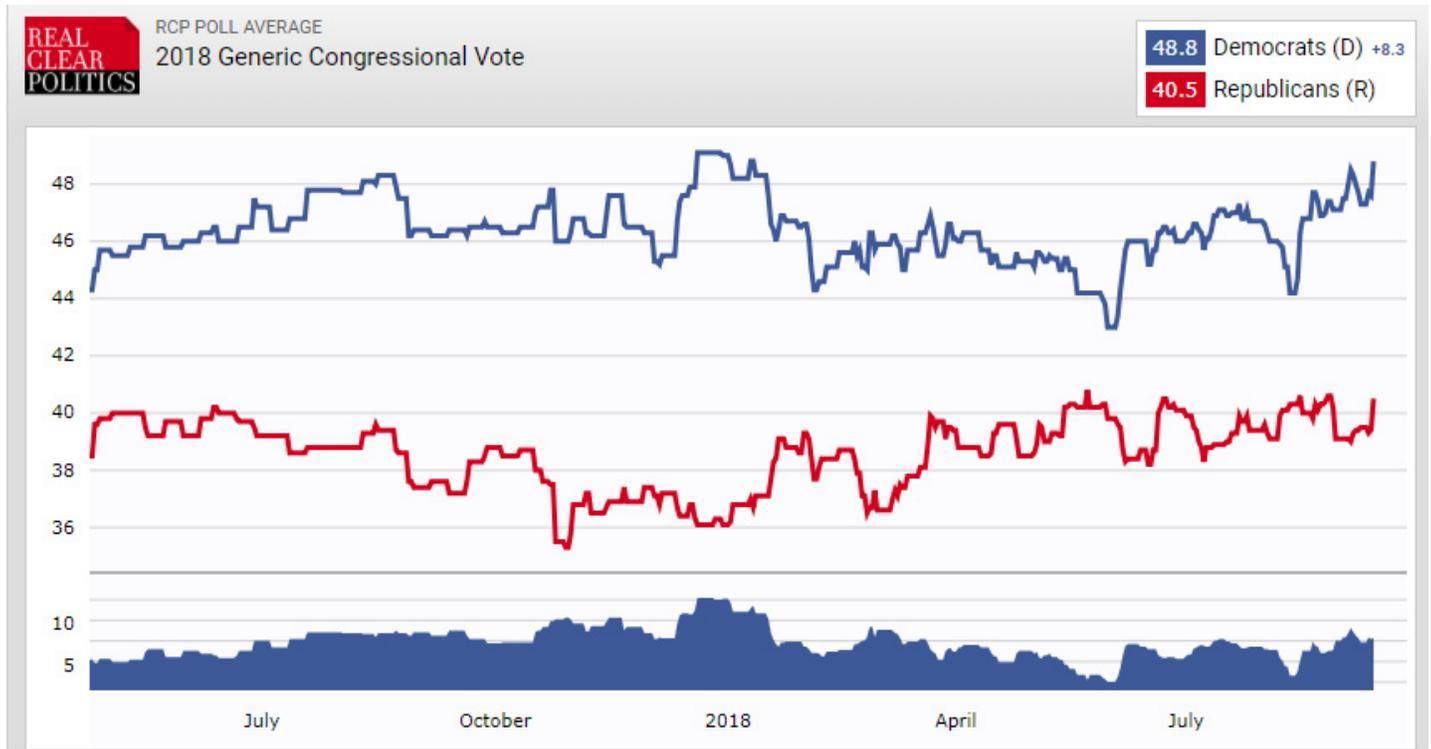
Note: Contested races defined as those with at least two candidates' names on the primary election ballot.
Source: Pew Research Center analysis of state election data.

PEW RESEARCH CENTER

Source: “Turnout in this year’s U.S. House primaries is up,” Pew Research, July 27, 2018

Geographic location of most voters

However, the apparent greater voter enthusiasm of the Democratic base is at least partially counteracted by two factors working in the Republicans' favour. 1) The tendency for Democrats to win with overwhelming margins in heavily Democratic urban areas, thus wasting votes; and 2) gerrymandering, which is the process whereby state governors redraw the boundaries of legislative districts to favour their party, essentially by moving likely non-supporters to districts lost in advance. **In order to overcome these barriers and have a chance of regaining control of the House of Representatives, Democrats would have to win the congressional popular vote by at least 7 percentage points.** As the following chart illustrates, they are currently just above this threshold in the polls.

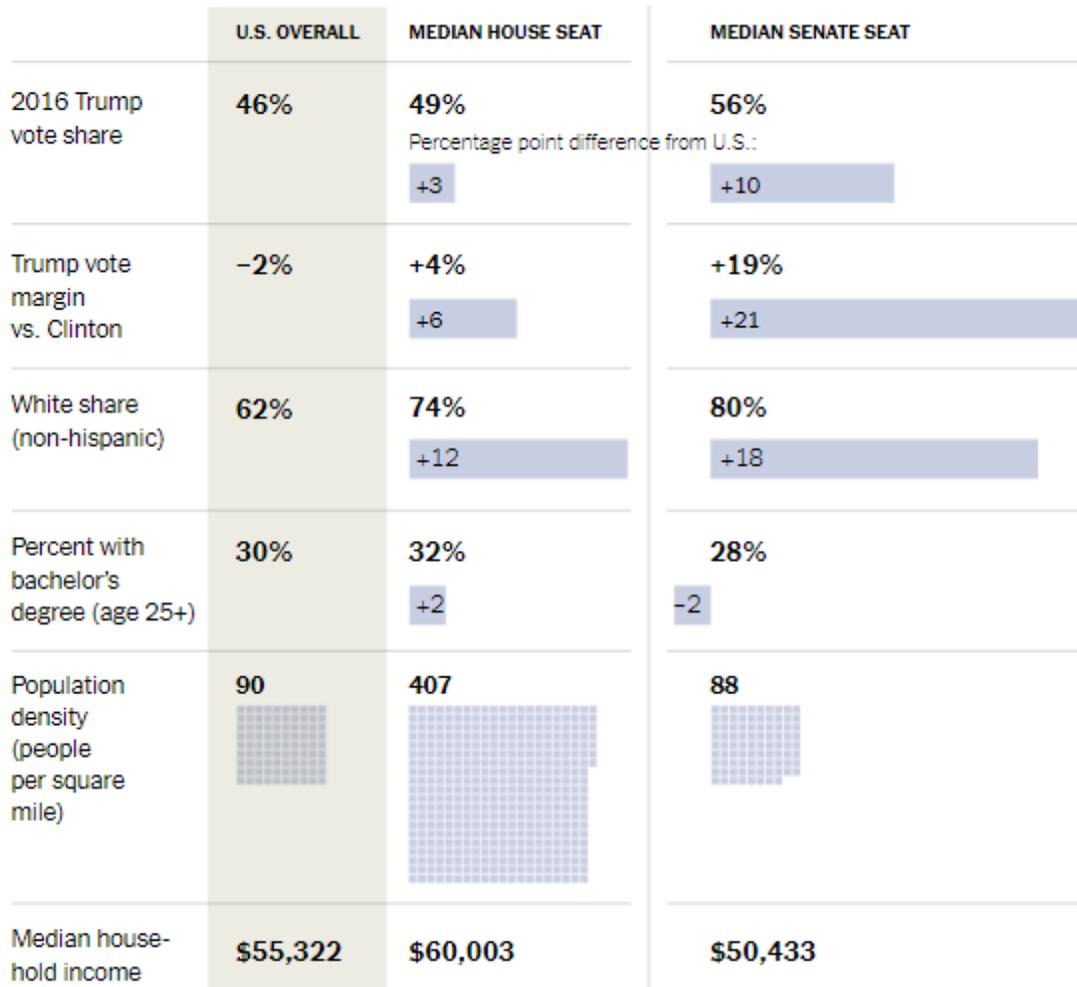


The midterms also hugely important for gerrymandering

Most state governors, also, are up for re-election in November 2018. The winners will be in a position to reshape the house electoral districts of their state during the 2020 national census, an exercise conducted every ten years. During the last census, Republican governors were able to shape federal districts in a way that greatly benefitted the Republicans in the 2010 midterm congressional elections.

Senate map favours Republicans

Though their majority hangs by only a two-vote margin (51 to 49), Republicans are relatively well-positioned to retain control of the Senate. Democrats will be defending 26 seats, compared with just 9 for Republicans. This includes ten Democratic seats in regions that Trump won in the last presidential election. In contrast, only one Republican seat is at stake in a state that Clinton won (Nevada). As illustrated in the following chart, the median Senate seat is more rural and pro-Trump than is the median House seat. Regardless of population, each state has two senators.



Source: "Why Even a Blue Wave Could Have Limited Gains," New York Times. August 20, 2018

What if Democrats win the House of Representatives?

- The GOP would not be able to pass any more major bills with just Republican support.
- A Democratic House Majority would gain control of all of the investigative committees and launch several new investigations into the Trump administration.
- Regardless of whether Muller has completed his investigation, it would increase the risk of Democrats beginning impeachment proceedings against Trump (more on this later).

What if Democrats take the Senate as well?

Democrats gaining control of the Senate would be an even greater blow to the Trump administration. First, it would give Democrats veto power over Trump's nomination of judges and heads of regulatory agencies. Second, Democrats would be able to launch investigations against Trump from the Senate.

How difficult is it to impeach a president?

The process of removing a president from office for an alleged criminal offence begins in the House of Representatives. If a simple majority (50+1) votes to begin impeachment proceedings, the matter proceeds to the Senate, where a two-third majority (67 votes) is then required to actually remove a president from office. Impeachment has been attempted only three times in the history of the United States:

- In 1868, the House voted to impeach Andrew Johnson for firing the Secretary of War. The Senate fell just one vote short of the two-third majority needed for the motion to pass.
- In 1974, Richard Nixon resigned from the presidency when it became clear he would be impeached by the House and convicted by the Senate for crimes related to the Watergate scandal.
- In 1998, the House voted to impeach Bill Clinton for lying under oath about having an affair with intern Monica Lewinsky, but the motion failed to muster sufficient votes in the Senate.

There is a risk, also, of the impeachment inquiry drifting towards unrelated matters. In the 1990s, Kenneth Starr was appointed Independent Counsel to investigate then President Bill Clinton's involvement in a failed real estate investment deal. The probe ultimately led to impeachment proceedings against Clinton for lying under oath about his affair with an intern. **In our opinion, the biggest risk that President Trump faces is not being found guilty of collusion with Russia but being charged or targeted for impeachment for something unrelated, such as lying under oath about his business dealings or taxes.**

What stands in the way of Trump's impeachment?

While many congressional Republicans do not like Trump, they are kept in line by the fact that the vast majority of Republican voters still support him. Attacking the President would be electoral suicide for them. **However, this reluctance to turn against President Trump could begin to crumble if investigations reveal that Trump committed a major crime and/or if his popularity among the Republican base collapses (see chart below).** If his approval rating among the Republican rank and file were to drop below 70% for a prolonged period Trump would have reason to worry.

Donald Trump Job Approval by Party Identification

Weekly averages from Gallup Daily tracking

	Republicans	Independents	Democrats
	%	%	%
2018			
2018 Sep 3-9	85	36	8
2018 Aug 27-Sep 2	85	36	9
2018 Aug 20-26	85	35	10
2018 Aug 13-19	87	39	7
2018 Aug 6-12	82	34	7
2018 Jul 30-Aug 5	89	33	7
2018 Jul 23-29	87	34	8
2018 Jul 16-22	85	37	11
2018 Jul 9-15	90	38	8
2018 Jul 2-8	87	36	9
2018 Jun 25-Jul 1	87	36	10
2018 Jun 18-24	87	38	5
2018 Jun 11-17	90	42	10
2018 Jun 4-10	90	35	8
2018 May 28-Jun 3	87	34	11
2018 May 21-27	85	35	8
2018 May 14-20	89	38	9
2018 May 7-13	84	35	12

Partisan divide over Mueller investigation

The recent convictions of President Trump’s former campaign chairman Paul Manafort and his long-time lawyer Michael Cohen are cases in point. To Trump’s detractors, they can provide valuable information on Trump’s alleged Russian dealings in exchange for a lenient plea deal. To Trump’s supporters, however, the fact they have both been charged for matters unrelated to the Russian investigation is proof Mueller is nowhere near to proving that Trump colluded with the Russians.

Harvard Law Professor Alan M. Dershowitz has labelled this bitter divide “the criminalization of political differences” where only errors made by members of one’s own political tribe are forgiven.

Conclusion

The most likely outcome of the midterms is a split decision between the House and the Senate. This would mean a Democratic House majority launching more investigations against Trump and perhaps even beginning impeachment proceedings. While impeachment proceedings would most likely be unsuccessful, they would create a major distraction. At the same time, a Republican Senate majority would continue confirming the President’s judicial and government appointees.

Whether Republicans manage to cling to a majority in the House and/or the Senate or whether Democrats take control, power struggles and divisions within both parties mean there will be more gridlock. Indeed, the members of both parties most likely to lose their seats in 2018 are moderates who in the past have worked across the aisle.

Similar to Obama after losing control of the Congress in 2010, President Trump will likely have to rely on executive orders and regulatory agencies to advance his agenda. (Heads of regulatory agencies can often implement changes without congressional approval.)

Finally, losing seats in the midterms is not necessarily a career ender. Presidents Reagan in 1982, Clinton in 1994 and Obama in 2010 suffered major losses in their first midterm elections and still managed to get re-elected.

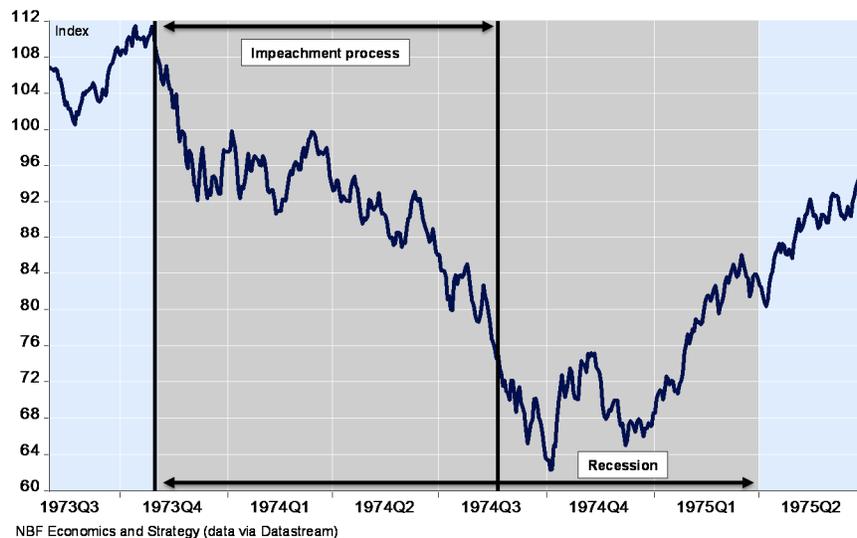
Where Trump's favourability is concerned, investors are advised to monitor Trump's support among the Republican rank and file and the right-leaning media very closely. Were Trump to lose this support, he would be in serious political trouble and much more vulnerable to impeachment.

Past impeachment episodes have had limited impact on financial markets

In February 1974, when Congress initiated impeachment proceedings against Nixon (resigned in August), the S&P 500 was already trending downward. While his impeachment no doubt added to the gloom, the main driver behind this bear market was the oil crisis and the collapse of the dollar-gold peg.

S&P 500: Perspective on Nixon's impeachment process

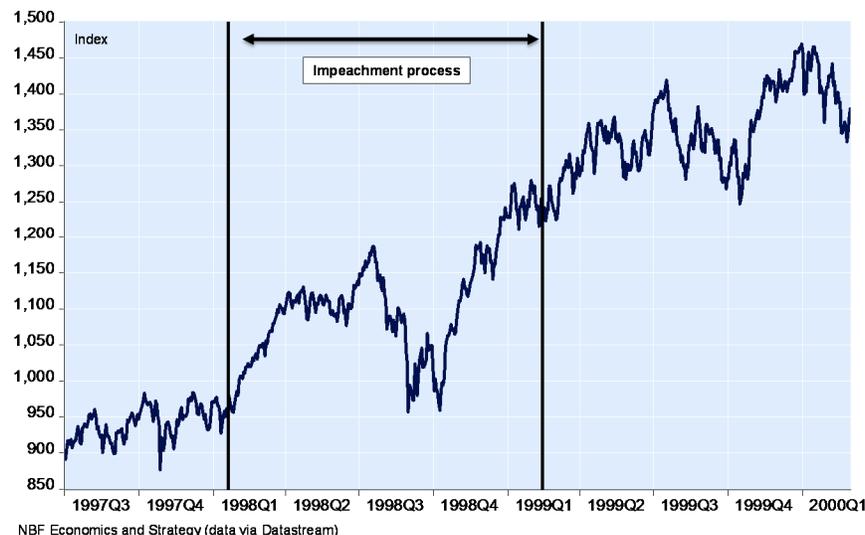
S&P 500 Composite Index



In contrast, Clinton's impeachment episode (December 1998 to February 1999) was marked only by a brief market correction caused by the Asian crisis. Quick actions by the Federal Reserve and the IMF quickly put markets back on the uptrend.

S&P 500: Perspective on Clinton's impeachment process

S&P 500 Composite Index



Why protectionism will outlast Trump

Regardless of who wins the midterms and the next presidential election in 2020, protectionism will remain part of the American political landscape for the foreseeable future. A quote from a letter sent last April by Democratic Senate leader Chuck Schumer regarding NAFTA negotiations to the Trump administration is a case in point: “I strongly believe that we should not miss this opportunity to protect our dairy producers from Canada’s recent predatory trade practices.”²

Further proof can be found in a bill recently passed with strong bipartisan support called the Foreign Investment Risk Review Modernization Act. This legislation not only strengthens the ability of the Department of Defense to decide who should be allowed to invest in the United States, it also makes it a lot harder for American companies to form joint ventures in countries like China, the main target of this legislation. One of the very few things Democrats and Republicans agree on is that a tougher line should be taken against China’s trade policies.

Democrats have veered left on many issues

While much has been said about the Republican Party’s ideological shift under Trump, it is important to note that the Democrats, too, are undergoing a major realignment of their own. This can be seen from their growing support for government-provided health insurance, guaranteed income schemes and tuition-free education. A recent Gallup poll found that a higher percentage of Democrats had a more positive view of socialism than of capitalism.

Views About Capitalism and Socialism: by Party

	Positive view of capitalism	Positive view of socialism
	%	%
Democrats/Leaners		
2018	47	57
2016	56	58
2012	55	53
2010	53	53
Republicans/Leaners		
2018	71	16
2016	68	13
2012	72	23
2010	72	17

GALLUP

Source: “Democrats More Positive About Socialism Than Capitalism,” Gallup, August 13, 2018

Angelo Katsoras

² “Senior U.S. legislator: new NAFTA must lower Canada’s ‘dairy wall,’” Canadian Press, April 16, 2018

Economics and Strategy

Montreal Office

514-879-2529

Stéfane Marion

Chief Economist and Strategist
stefane.marion@nbc.ca

Matthieu Arseneau

Deputy Chief Economist
matthieu.arseneau@nbc.ca

Krishen Rangasamy

Senior Economist
krishen.rangasamy@nbc.ca

Paul-André Pinsonnault

Senior Fixed Income Economist
paulandre.pinsonnault@nbc.ca

Marc Pinsonneault

Senior Economist
marc.pinsonneault@nbc.ca

Kyle Dahms

Economist
kyle.dahms@nbc.ca

Jocelyn Paquet

Economist
jocelyn.paquet@nbc.ca

Angelo Katsoras

Geopolitical Analyst
angelo.katsoras@nbc.ca

Toronto Office

416-869-8598

Warren Lovely

MD & Head of Public Sector Strategy
warren.lovely@nbc.ca

General

This Report was prepared by National Bank Financial, Inc. (NBF), (a Canadian investment dealer, member of IIROC), an indirect wholly owned subsidiary of National Bank of Canada. National Bank of Canada is a public company listed on the Toronto Stock Exchange.

The particulars contained herein were obtained from sources which we believe to be reliable but are not guaranteed by us and may be incomplete and may be subject to change without notice. The information is current as of the date of this document. Neither the author nor NBF assumes any obligation to update the information or advise on further developments relating to the topics or securities discussed. The opinions expressed are based upon the author(s) analysis and interpretation of these particulars and are not to be construed as a solicitation or offer to buy or sell the securities mentioned herein, and nothing in this Report constitutes a representation that any investment strategy or recommendation contained herein is suitable or appropriate to a recipient's individual circumstances. In all cases, investors should conduct their own investigation and analysis of such information before taking or omitting to take any action in relation to securities or markets that are analyzed in this Report. The Report alone is not intended to form the basis for an investment decision, or to replace any due diligence or analytical work required by you in making an investment decision.

This Report is for distribution only under such circumstances as may be permitted by applicable law. This Report is not directed at you if NBF or any affiliate distributing this Report is prohibited or restricted by any legislation or regulation in any jurisdiction from making it available to you. You should satisfy yourself before reading it that NBF is permitted to provide this Report to you under relevant legislation and regulations.

National Bank of Canada Financial Markets is a trade name used by National Bank Financial and National Bank of Canada Financial Inc.

National Bank Financial Inc. or an affiliate thereof, owns or controls an equity interest in TMX Group Limited ("TMX Group") and has a nominee director serving on the TMX Group's board of directors. As such, each such investment dealer may be considered to have an economic interest in the listing of securities on any exchange owned or operated by TMX Group, including the Toronto Stock Exchange, the TSX Venture Exchange and the Alpha Exchange. No person or company is required to obtain products or services from TMX Group or its affiliates as a condition of any such dealer supplying or continuing to supply a product or service.

Canadian Residents

NBF or its affiliates may engage in any trading strategies described herein for their own account or on a discretionary basis on behalf of certain clients and as market conditions change, may amend or change investment strategy including full and complete divestment. The trading interests of NBF and its affiliates may also be contrary to any opinions expressed in this Report.

NBF or its affiliates often act as financial advisor, agent or underwriter for certain issuers mentioned herein and may receive remuneration for its services. As well NBF and its affiliates and/or their officers, directors, representatives, associates, may have a position in the securities mentioned herein and may make purchases and/or sales of these securities from time to time in the open market or otherwise. NBF and its affiliates may make a market in securities mentioned in this Report. This Report may not be independent of the proprietary interests of NBF and its affiliates.

This Report is not considered a research product under Canadian law and regulation, and consequently is not governed by Canadian rules applicable to the publication and distribution of research Reports, including relevant restrictions or disclosures required to be included in research Reports.

UK Residents

This Report is a marketing document. This Report has not been prepared in accordance with EU legal requirements designed to promote the independence of investment research and it is not subject to any prohibition on dealing ahead of the dissemination of investment research. In respect of the distribution of this Report to UK residents, NBF has approved the contents (including, where necessary, for the purposes of Section 21(1) of the Financial Services and Markets Act 2000). This Report is for information purposes only and does not constitute a personal recommendation, or investment, legal or tax advice. NBF and/or its parent and/or any companies within or affiliates of the National Bank of Canada group and/or any of their directors, officers and employees may have or may have had interests or long or short positions in, and may at any time make purchases and/or sales as principal or agent, or may act or may have acted as market maker in the relevant investments or related investments discussed in this Report, or may act or have acted as investment and/or commercial banker with respect hereto. The value of investments, and the income derived from them, can go down as well as up and you may not get back the amount invested. Past performance is not a guide to future performance. If an investment is denominated in a foreign currency, rates of exchange may have an adverse effect on the value of the investment. Investments which are illiquid may be difficult to sell or realise; it may also be difficult to obtain reliable information about their value or the extent of the risks to which they are exposed. Certain transactions, including those involving futures, swaps, and other derivatives, give rise to substantial risk and are not suitable for all investors. The investments contained in this Report are not available to retail customers and this Report is not for distribution to retail clients (within the meaning of the rules of the Financial Conduct Authority). Persons who are retail clients should not act or rely upon the information in this Report. This Report does not constitute or form part of any offer for sale or subscription of or solicitation of any offer to buy or subscribe for the securities described herein nor shall it or any part of it form the basis of or be relied on in connection with any contract or commitment whatsoever.

Geopolitical Briefing

This information is only for distribution to Eligible Counterparties and Professional Clients in the United Kingdom within the meaning of the rules of the Financial Conduct Authority. NBF is authorised and regulated by the Financial Conduct Authority and has its registered office at 71 Fenchurch Street, London, EC3M 4HD.

NBF is not authorised by the Prudential Regulation Authority and the Financial Conduct Authority to accept deposits in the United Kingdom.

U.S. Residents

With respect to the distribution of this report in the United States of America, National Bank of Canada Financial Inc. ("NBCFI") which is regulated by the Financial Industry Regulatory Authority (FINRA) and a member of the Securities Investor Protection Corporation (SIPC), an affiliate of NBF, accepts responsibility for its contents, subject to any terms set out above. To make further inquiry related to this report, or to effect any transaction, United States residents should contact their NBCFI registered representative.

This report is not a research report and is intended for Major U.S. Institutional Investors only.
This report is not subject to U.S. independence and disclosure standards applicable to research reports.

HK Residents

With respect to the distribution of this report in Hong Kong by NBC Financial Markets Asia Limited ("NBCFMA") which is licensed by the Securities and Futures Commission ("SFC") to conduct Type 1 (dealing in securities) and Type 3 (leveraged foreign exchange trading) regulated activities, the contents of this report are solely for informational purposes. It has not been approved by, reviewed by, verified by or filed with any regulator in Hong Kong. Nothing herein is a recommendation, advice, offer or solicitation to buy or sell a product or service, nor an official confirmation of any transaction. None of the products issuers, NBCFMA or its affiliates or other persons or entities named herein are obliged to notify you of changes to any information and none of the foregoing assume any loss suffered by you in reliance of such information.

The content of this report may contain information about investment products which are not authorized by SFC for offering to the public in Hong Kong and such information will only be available to, those persons who are Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong ("SFO")). If you are in any doubt as to your status you should consult a financial adviser or contact us. This material is not meant to be marketing materials and is not intended for public distribution. Please note that neither this material nor the product referred to is authorized for sale by SFC. Please refer to product prospectus for full details.

There may be conflicts of interest relating to NBCFMA or its affiliates' businesses. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by NBCFMA or its affiliates, or in other investment vehicles which are managed by NBCFMA or its affiliates that may purchase or sell such securities and instruments.

No other entity within the National Bank of Canada group, including National Bank of Canada and National Bank Financial Inc, is licensed or registered with the SFC. Accordingly, such entities and their employees are not permitted and do not intend to: (i) carry on a business in any regulated activity in Hong Kong; (ii) hold themselves out as carrying on a business in any regulated activity in Hong Kong; or (iii) actively market their services to the Hong Kong public.

Copyright

This Report may not be reproduced in whole or in part, or further distributed or published or referred to in any manner whatsoever, nor may the information, opinions or conclusions contained in it be referred to without in each case the prior express written consent of NBF.