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Democrats set to lose the keys to Congress

The Democrats look set to lose control of Congress in November's midterm elections, barring an upset. This will kill President Biden's legislative agenda, and limit the scale of any fiscal stimulus if a recession occurs next year.

Key takeaways

- Democrats have used unified government to deliver some major pieces of legislation over the past two years, though they did not pass the key 'social infrastructure' pledges from the 2020 campaign.
- Biden's large $1.9tn Covid relief legislation shaped an initially fast but also very inflationary post-pandemic recovery. Latterly, the Inflation Reduction Act created winners and losers across the corporate sector via its impact on climate, healthcare and tax policy, and is set to accelerate America's energy transition.
- The Democrats are likely to lose the House in the midterm elections, as the party battles the headwinds of incumbency, inflation, redistricting and having more marginal seats to defend. The Senate is a closer call, but Democrats are more likely to hold their majority given the favourable match-ups and electoral map.
- A split Congress would see Democrats lose control of the legislative levers of government. That should lead to partisan gridlock, stymying the President's legislative agenda and push him towards more active foreign policy and executive actions. This would also constrain any fiscal response to a recession, putting the onus on the Fed to drive the recovery.
- Democrat losses are firmly baked into market consensus, but there is a chance they can hold on to the House, especially if issues like abortion rights help energise voter turnout. This would open the door to more legislative action, but the ambition will depend on their margin and the extent to which Senators Manchin and Sinema retain their effective veto power.
- The results will also shape the narrative of which party is on the right path leading up to the more important 2024 presidential elections. We are watching how Trump-sponsored candidates fare especially closely.

Democrats on the defensive

The midterms will see all 435 of the seats in the House of Representatives and 35 of the 100 Senate seats on the ballot on Tuesday November 8th. In the run up to the vote Democrats hold a narrow majority of just five seats in the House and require Vice President Harris's tie breaking vote to overcome a 50-50 deadlock with Republicans in the Senate.

There are a number of cyclical and structural factors which threaten both these working majorities in November.

Incumbent backlash. Over recent years the party holding the White House has lost 30 seats in the House on average, which if replicated would comfortably flip the House Republican.

Redistricting. Redistricting is expected to net Republicans 3-5 seats on aggregate reflecting a pooling of voting bases in more electorally favourable districts for Republicans.

A challenging map. Democrats currently hold 29 seats in the House judged to be a toss-up or worse, well above the Republicans 12 seats of this type.

Inflation. High inflation has been politically unpopular, as seen in President Biden's headline approval rating and measures on his handling of the economy. This theme has eased a little on the back of falling gasoline petrol, but jobs and the economy remains a top issue and potential democrat weakness in many polls. Against this backdrop the consensus has been for some time that Democrats would lose one, or both chambers of Congress.

Don't call it a comeback

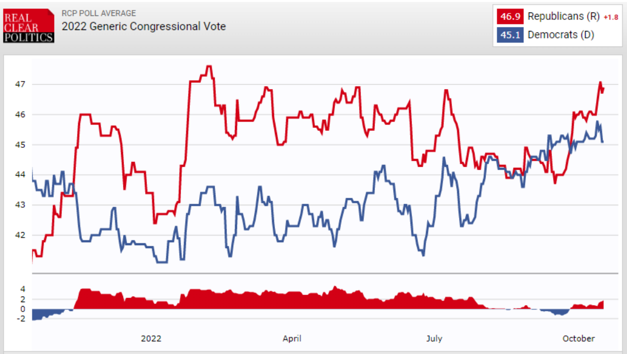
However, there are a couple of factors which are at least tilting in the Democrats favour recently. The first is the focus on abortion rights in the wake of the recent Supreme Court ruling. There is evidence this has energised Democrat and independent voters, particularly women. This was the case ahead of a vote in Kansas on a constitutional amendment to restrict abortion access, with women registering at twice the rates of men. Higher registration and turnout could provide a significant boost to Democrats.

Candidate selection is also proving important in a number of key battleground states. Former President Trump endorsed candidates have won primaries in states like Arizona, Pennsylvania and Georgia, offering very conservative policy positions and hard-line stances on abortion rights that are out of kilter with the views of the median voter. In some cases they have also faced major credibility issues. This risks negating some of the structural and cyclical headwinds supporting the GOP.

Polling still gives Republicans the edge

Since the summer we have seen an improvement in the Democrat generic polling numbers. A gap that was as large as 4ppts was closed in the fall before widening to 2ppts more recently (see Figure 1).

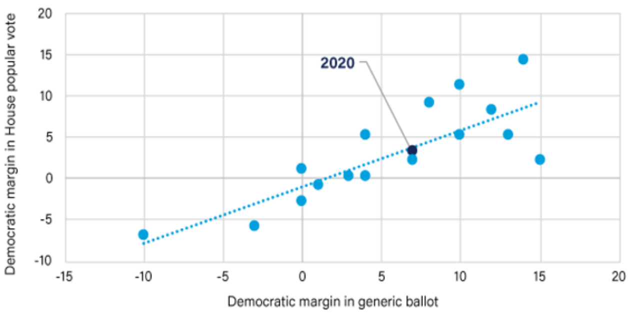
Figure 1: Democrats have made up ground in the polls



Source: Realclearpolitics (as of Oct 2022)

Unless there is a late swing, or the polls turn out to be biased against the Democrats, the current gap suggests it will be hard for them to retain the House. Indeed, past elections have shown that they need a large advantage in these to see that translate into a majority of seats (see Figure 2).

Figure 2: Generic ballot vs House election results

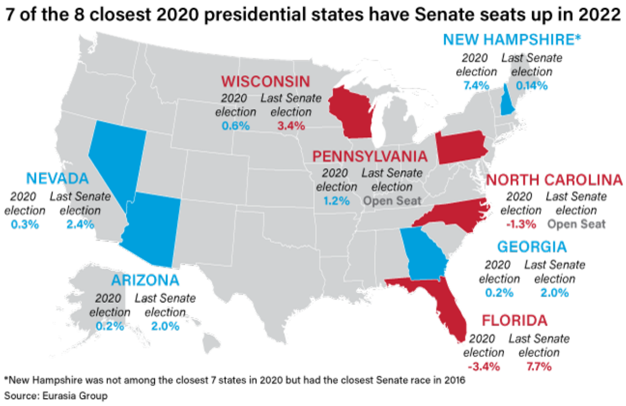


Source: Eurasia Group (as of Oct 2022)

The 2020 election was a good example of this phenomenon. A near 5% advantage in polling resulted in a narrow majority of just 5 seats. This finding is mirrored in 538's analysis, which shows Democrats with just a 30% chance of holding the House, although that has doubled since June.

In the Senate, the majority of seats up for election are considered solid Republican (14) or solid Democrat (9). Of the other competitive seats, the Republicans will be focussed on holding Pennsylvania and Wisconsin while looking to pick up one of Georgia, Nevada, Arizona and New Hampshire in order to gain a majority (see Figure 3).

Figure 3: The Senate will be decided by a smallish number of close races



Source: Eurasia Group (as of Oct 2022)

All these pick-up seats are rated either a toss-up or lean Democrat, with the candidate selection issue flagged above a headwind in all of these states bar Nevada (see Figure 4). Indeed, the combination of this, and the improvement in overall polling, has pushed the chances of Democrats retaining the Senate up from around 40% in June to 66% at present according to 538's model.

Figure 4: Cook report ranking of close Senate seats

Lean Democrat	Toss-up	Lean Republican
AZ-Kelly	GA-Warnock	FL-Rubio
CO-Bennet	NV-Cortez Masto	NC-Open
NH-Hassan	PA-Open	OH-Open
	WI-Johnson	

Colour reflects incumbent party (Blue = Democrat, Red = Republican)

Source: The Cook report (as of Oct 2022)

Of course, we know well how wrong polls can be, and particularly their tendency to underestimate Republican support in some key battleground states in some recent cycles. If we saw similar polling errors as in 2020 the current Democrat leads in key battleground Senate seat states like Wisconsin, Nevada and Georgia would evaporate. Pollsters have been trying to again address some of their sample bias issues, but it is not clear how successful they have been in contacting a proportionate share of Republican voters in some of these key states. This is another factor which might lean in Republicans favour come election day.

A long shot for Democrats

Taking all the drivers together, and within the context of current aggregate and individual race polling, we think a split Congress is the most likely outcome in November, with Democrats losing the House and retaining the Senate. As always, however, we also make use of scenario analysis to reflect the uncertainties and make sure we understand the impacts of all the plausible outcomes

The bad news for the Democrats is our second most likely scenario is that they lose both chambers, with those Senate match-ups breaking towards Republican candidates. That leaves a blue wave as the least likely, but far from impossible, outcome. This would require further advances in generic polling, strong turnout from motivated voters on the day, continued missteps from Republican candidates in key races, with a dose of polling bias thrown in.

Get ready for policy gridlock

A split, or Republican controlled Congress, would effectively deliver legislative gridlock for the rest of President Biden's term. While there was bipartisan support around last year's infrastructure bill and this year's Chips act to boost semiconductor production, these were very much the exceptions rather than the rule, with no Republicans voting for the recent Inflation Reduction Act. These divisions are likely to harden as focus shifts to the 2024 Presidential election cycle.

Gridlock probably even extends to fiscal support during the 2023 downturn that we are forecasting. Republicans could block support altogether, or at best agree on a small package aimed at extending unemployment insurance and minor countercyclical tax cuts. However, even this would be much smaller than required to meaningfully offset any shock, putting the pressure on the Fed to combat the downturn alone. This is one of the reasons we have rates back at the zero lower bound in 2024.

Faced with a split Congress, President Biden would pivot towards foreign policy and making greater use of his executive powers. This could mean a further focus on US diplomatic confrontations with China and Russia, with Biden having already been relatively robust on both this year. In practical terms we could see further action like the recent crackdown on the integration of the advanced semi-conductor supply chain with China

Gridlock could also mean a greater focus on regulation and executive orders, even if both of these are likely to be increasingly challenged by the Supreme Court. We saw this around the ruling on the Environmental Protection Agency, which restricted its powers to regulate carbon emissions. This ruling set the stage for other limitations on the regulatory power of Federal agencies.

Figure 5: Midterm election scenarios

Outcome	Waymarks	Policy implications	What this means for 2024
Split Congress	Generic polling remains tight, with Democrats unable to build further momentum. Senate head-to-heads continue to show narrow Democrat advantages in key states. Inflation remains robust and a major concern for voters	Policy gridlock likely, with President Biden unable to pass his legislative agenda. Risk of government shutdowns Fiscal stimulus likely to be blocked or at best small in the case of a recession next year. Biden to put greater focus on foreign policy and regulatory action via Executive Orders.	Policy gridlock could further increase fissures in the Democrat party ahead of 2024, and cast doubts over Biden's candidacy. Republicans failure to take the Senate could be a blow to Trump and his endorsed candidates.
Red wave	Generic polling remains tight, if not tilting in the favour of Republicans. Senate head-to-heads show building Republican momentum in toss-up or lean Democrat states. Inflation remains robust and a major concern for voters.	Policy gridlock, with President Biden even less likely to be able to pass any of his agenda. Even greater risk of government shutdowns as Republicans become more strident. Fiscal stimulus likely to be blocked or at best small and even more tilted to Republican demands. Biden to put greater focus on foreign policy and regulatory action via Executive Orders.	Deeper tensions in the Democrat party, and support for an alternative Presidential candidate in 2024. Republican success in the Senate might strength Trump's grip on the party given the performance of some of his endorsed candidates. More evidence of polling underselling Republican support.
Blue Wave	Democrats see some sustained gains in generic polling ahead of the November vote. Democrat candidates significantly outperform Republicans in key Senate races. Inflation starts to fall down the list of voter priorities, with a greater emphasis on abortion or voting rights for example. Signs emerge of high energy levels among Democrats.	Democrats might pass some of the social policy aspects of the Build Back Better program. Much depends on the size of any Senate majority, and who holds the effective balance of power. Fiscal policy would loosen more amid recession, but the scale of this might be limited by Manchin. Broader legislative action such as changes to the Supreme Court would require an adjustment of filibuster rules, which looks unlikely.	Democrats energised by holding Congress, with the wins seen as a potential endorsement of President Biden. Republicans failure to take the Senate could be a blow to Trump opening the window for other presidential and congressional candidates.

Source: abrdn (as of Oct 2022)

If the Democrats maintain control of the House and Senate their ambitions will be determined by the scale of majorities, particularly in the Senate. A 50-seat working majority would again be vulnerable to Senator Manchin's veto, especially given that he faces re-election in 2024. He has shown his sensitivity to deficit financed fiscal policy, especially against the backdrop of high inflation. Even 51 seats might be vulnerable to Senator Sinema, who has also refused to toe the Democrat party line at times.

Still, despite these potential roadblocks, Democrats have shown that they can get stuff done with wafer thin majorities and would likely provide a more robust fiscal response in the case of recession and look to pass a range of policies on their social agenda – like child tax credits – potentially financed by higher taxes.

A larger majority in the Senate is very unlikely, but it would open significantly more doors. This is true in terms of passing more ambitious fiscal legislation but also in terms of what it might mean for the filibuster. A 52-seat majority could open up the possibility of reform to allow greater legislative power with a simple rather than 60 seat majority.

If successful we could see new legislation on voter rights, the Supreme Court and adding DC as the 51st State. These changes would be in themselves significant, but more powerful would be the permanent loosening of checks on the legislative process, which could potentially lead to far more regular and significant changes in policy.

What to watch

Consensus ahead of the election seems to be firmly centred on Republicans wrestling control of at least part if not all of Congress. A view that we share. However, given the potentially large policy implications if Democrats can overcome the odds it is important to flag what might shift the balance in their direction.

Certainly, we will be watching the generic polls closely for signs that Democrat momentum continues to build into the vote. Recent inflation data remain unhelpful, but gas prices are easing, the labour market remains very strong and growth has yet to rollover. Democrats are also hoping to shift attention away from inflation to issues like abortion which they think can motivate their base and independents

Otherwise, we will be watching key Senate races closely for signs that Democrats are building advantages through campaigns. If so the possibility of a Democrat clean sweep increases, as does the likelihood that they have more of a majority to work with.

Our latest US forecasts

- **Activity:** Short term activity indicators are showing a rebound in activity in Q3, following contractions in the first half of this year. However, the increase will be flattered by net trade and inventory effects, with underlying consumer spending and business investment expected to be subdued. This weak domestic demand is expected to falter further as we move into Q4 and Q1, setting the stage for a recession next year.
- **Inflation**: The run rate of US inflation has slowed as lower commodity prices and cooling core goods prices help provide a degree of relief. However, of more concern is the continued acceleration in core services inflation, which in part reflects very strong gains in rents and owners' equivalent rents, but also a broader range of services prices. We have pushed our core inflation forecasts up slightly in the wake of these strong and sustained gains.
- **Monetary policy**: In the face of continued upside surprises in inflation and a still robust labour market we now expect more tightening from a very hawkish Fed. We expect rates to rise 75bps in November, 50bps in December (with risks of a larger move) and 50bps in January. Our base case is that slowing activity kills the tightening cycle after this point, but a more resilient economy could prompt further increases.

	2021	**2022**	**2023**	**2024**
GDP (%)	5.7	1.7	-0.4	-0.5
CPI (%)	4.7	8.1	4.0	2.1
Policy Rate (%, year-end)	0.1	4.4	3.4	0.1

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