Janus Henderson Investors

U.S. midterm elections: Option markets foresee divided Congress

Global Head of Asset Allocation Ash Alankar explains how the options market can be used to assess a range of potential outcomes of the upcoming U.S. midterm elections and, thus, play a useful role in identifying pockets of attractiveness in markets going forward.

05:13

Key takeaways:

- While U.S. stocks have consistently earned positive returns in the months following past midterm elections, we think there is reason to believe that streak could be broken this year.
- Historically, much of the strong post midterm-year equity performance has been driven by aggressive government spending. The current threat of inflation means any large pickup in government spending is unlikely going forward.
- The options market predicts that a divided Congress is the most likely outcome this year. In this scenario, a push by Democrats to move larger spending bills forward ahead of a split government in January could fuel inflationary pressures.

Important information

Our Adaptive Multi-Asset Solutions Team arrives at its outlook using options market prices to infer expected tail gains (ETG) and expected tail losses (ETL) for each asset class. The ratio of these two (ETG/ETL) provides signals about the risk-adjusted attractiveness of each asset class. We view this ratio as a “Tail-Based Sharpe Ratio.”

Ash Alankar: I know on top of all of our minds is inflation, for very good reasons. But the U.S. midterm elections are right around the corner, and the outcome for these elections will play a pretty helpful role in identifying pockets of attractiveness going forward. Now, history in the U.S. midterm elections paint a really rosy picture. Since the 1940s, 12 months post the elections, the S&P 500 has never experienced a loss. Quite phenomenal, right? So, does this mean going forward there’s free money to be made? Absolutely not.

This year in particular may be that year where this historical record is broken and history does not repeat itself. Reason number one, there has never been a recession which hit the third year of a presidential term, and it looks like [in] 2023, recession is likely to unfold. Reason number two, much of the strong post midterm-year equity performance has been driven by very aggressive government spending. And with the threat of inflation, we're unlikely to see any large pickup in government spending going forward. Given these reasons, this year in particular, you should pay attention, and it warrants to pay attention to the details of the election outcomes.

With that, let me give you my two-minute rundown of what to expect. Scenario number one: a Democratic sweep. This outcome is the lowest probability event priced by the betting market, sitting just at 10% probability. Under a Democratic sweep, you likely will see a fairly large pickup in government spending due to the Build Back Better Program. Now that's a mouthful; try saying that three times really fast. Sectors which are poised to benefit: alternative clean energies, hospitals, Medicaid HMOs, companies that are involved in the infrastructure of water, and broadband communications.

Now, scenario number two, a Republican sweep. Under a Republican sweep, you are unlikely to see any increases in taxes. You're unlikely to see any meaningful pickup in government spending. So-called "sin" sectors, i.e., prisons, tobacco, for-profit education, student lending … these sectors are likely to catch a bid on the prospects of reduced negative legislation against them. Sectors involved in the military, national security, are likely to benefit from increased government spending. Fossil fuel industries are also likely to benefit. Most importantly, with the Republican sweep, you have a split government. A split government is the best government for financial assets and for equities. As they say, let capitalism do what capitalism does best with as little interference by the government and as little policy uncertainty.

Now this brings us to the last scenario, which is a divided Congress. The betting markets here are assigning a slightly lower probability, at 30%, for a divided or a split Congress. Interestingly, under this scenario you likely will see a big push by the Democrats to move forward some of their larger or more important government spending bills as Republicans look to build goodwill as a split Congress comes into place come January.

So, what do we see as the most likely outcome? The option markets historically have done a very good job in pricing of that risk and predicting the outcome of events. The option market today sees the most likely scenario to be a divided Congress. A basket of stocks that are expected to do really well under a Democratic sweep look equally attractive according to the lens of the options market as a basket of stocks which are expected to do quite well under a Republican sweep. The upside-to-downside volatilities of both of these baskets are very similar, with the Republican basket having a slight edge. So, don't be surprised come January, where you see a divided Congress, and don't be surprised if you see an acceleration and a strong push by the Democrats to move forward some of their more important spending bills between now and the coming of the divided Congress in January, which unfortunately may also fuel some inflationary pressures, so be wary of the bond markets here.