United States

Midterm elections on the eve of a recession

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Executive summary: Good-bye, unified government!

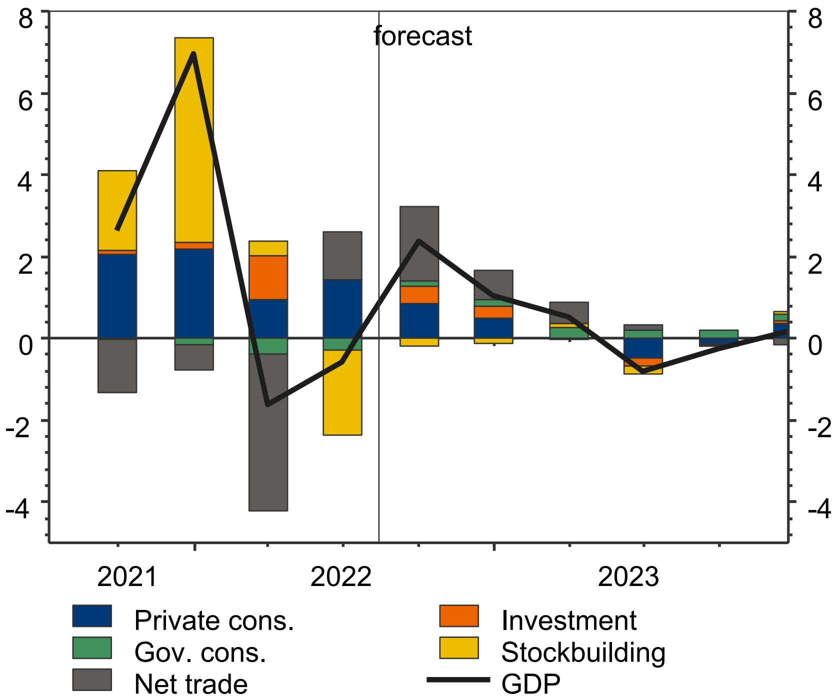
- The 2022 midterm elections are likely to usher in another phase of **divided government**, after 2 years of Democratic control of both Congress and the Presidency.
- Currently, the central scenario is for a **Republican majority in the House and for a slim Democratic margin in the Senate**, opening up a 2-year period of political stalemate. The uncertainty of the result in the Senate has been increasing in recent weeks, with an improvement of Republicans in the polls.
- The Administration is likely to resort to executive orders in the areas of foreign policy, international trade and, possibly, immigration, to obtain some visible political results before the next elections.
- The lack of room for legislative manoeuvre may be challenging in 2023, when a recession is likely to hit the economy, in the wake of restrictive monetary policy aimed at reining in inflation. The economic policy action will be in the hands of the Fed, with **fiscal policy mostly frozen.**

Agenda

1	The economy is on the eve of a recession
2	Monetary policy is the only game in town
3	Political outlook: two years of stalemate ahead

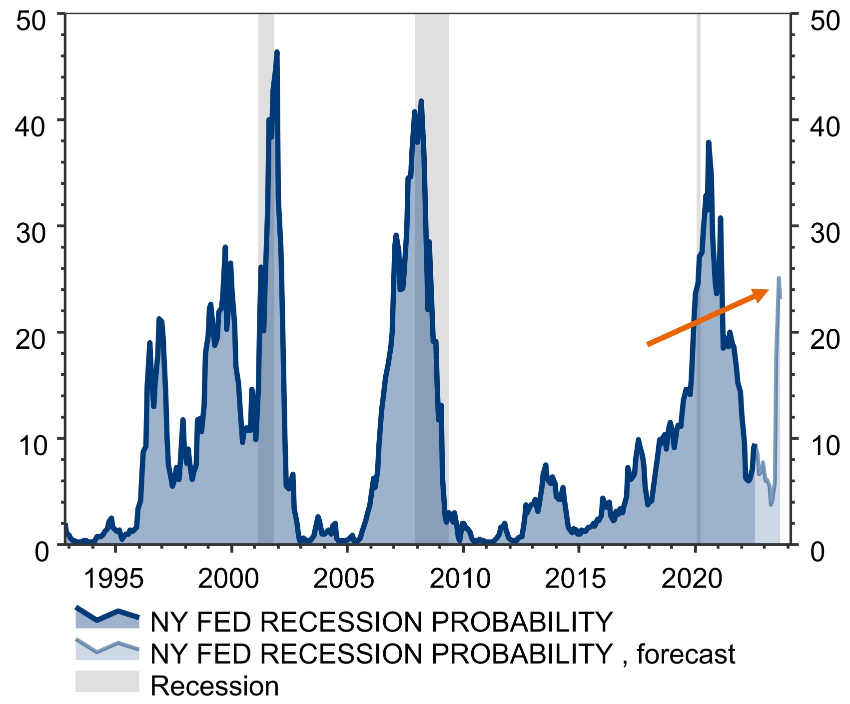
A recession is all but guaranteed in 2023

The economy is slowing…



Source: BEA, Intesa Sanpaolo forecasts

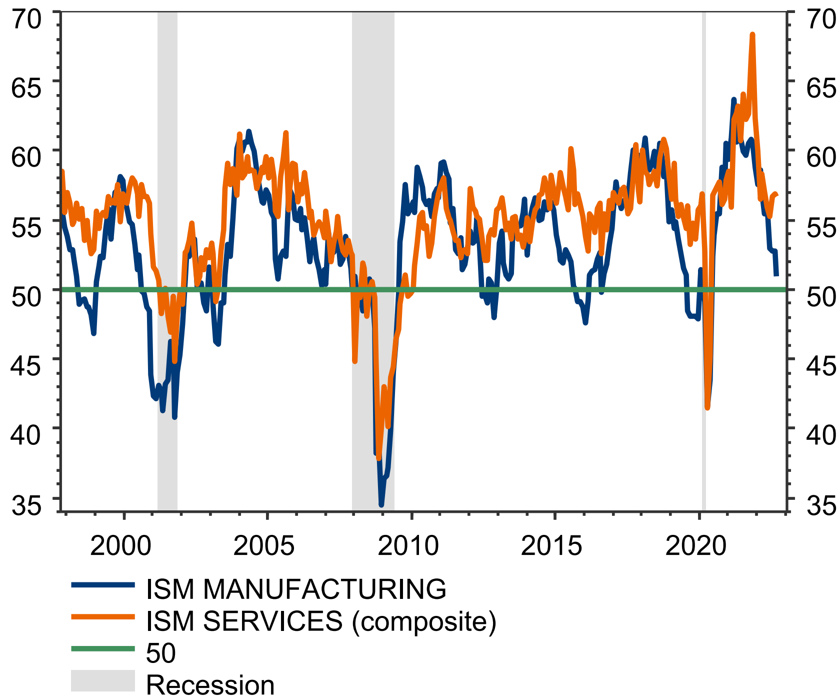
…and a recession is coming



Source: NY Fed

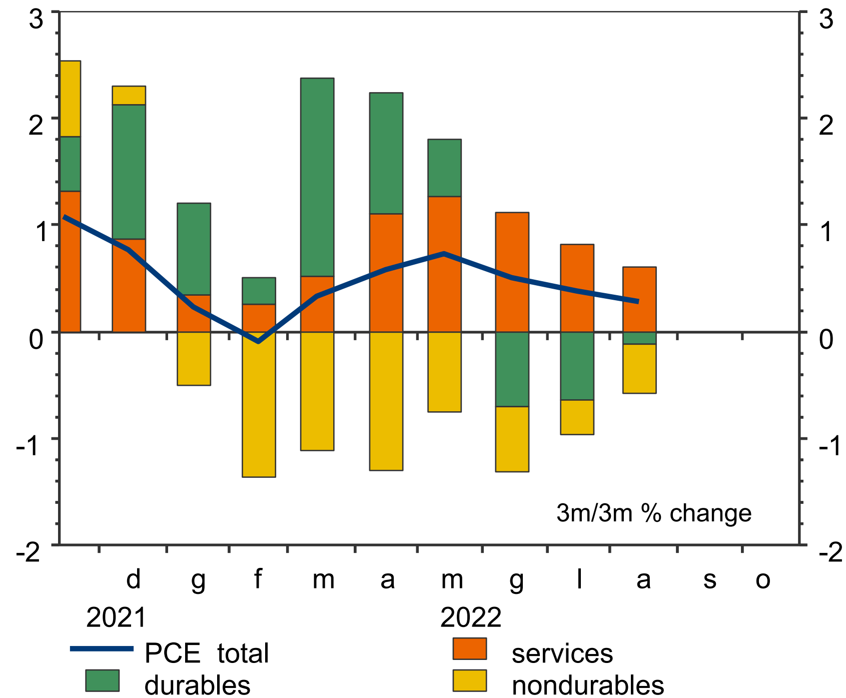
Services are holding up, manufacturing is slowing down

Services are still carrying the day…



Source: ISM

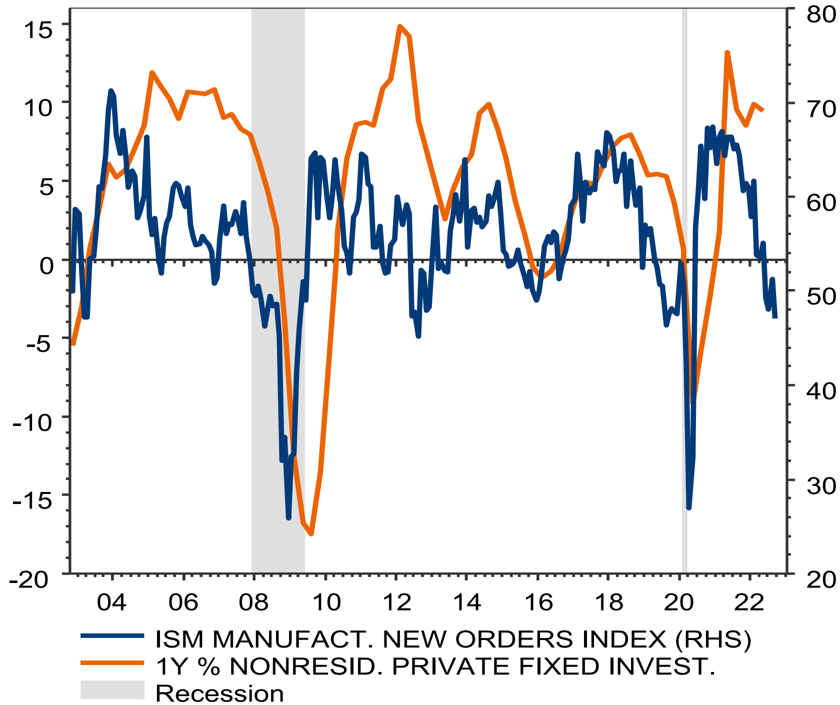
…as consumers catch up after the pandemic



Source: BEA

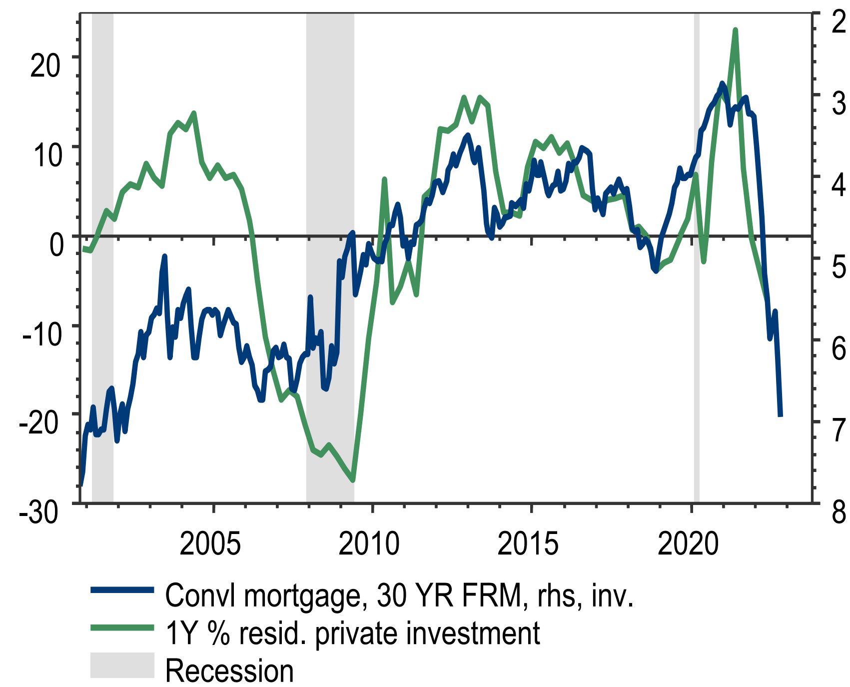
Fixed investment: the transmission mechanism that never fails

It is only a matter of time before non-residential investment turns down



Source: BEA, ISM

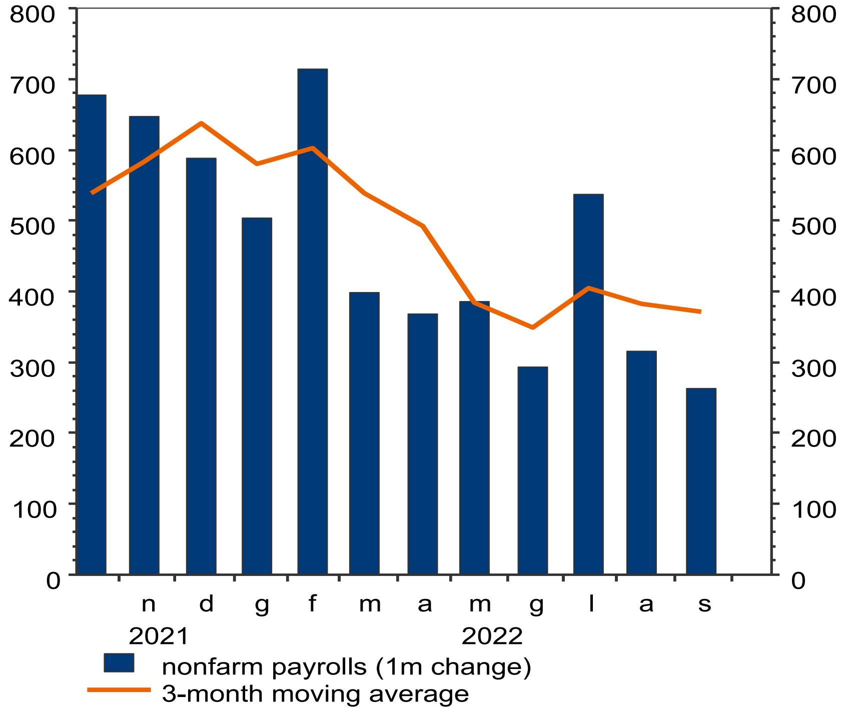
Residential investment is already plunging, and will keep doing so in 2023



Source: BEA. S&P, Refinitiv-Datastream

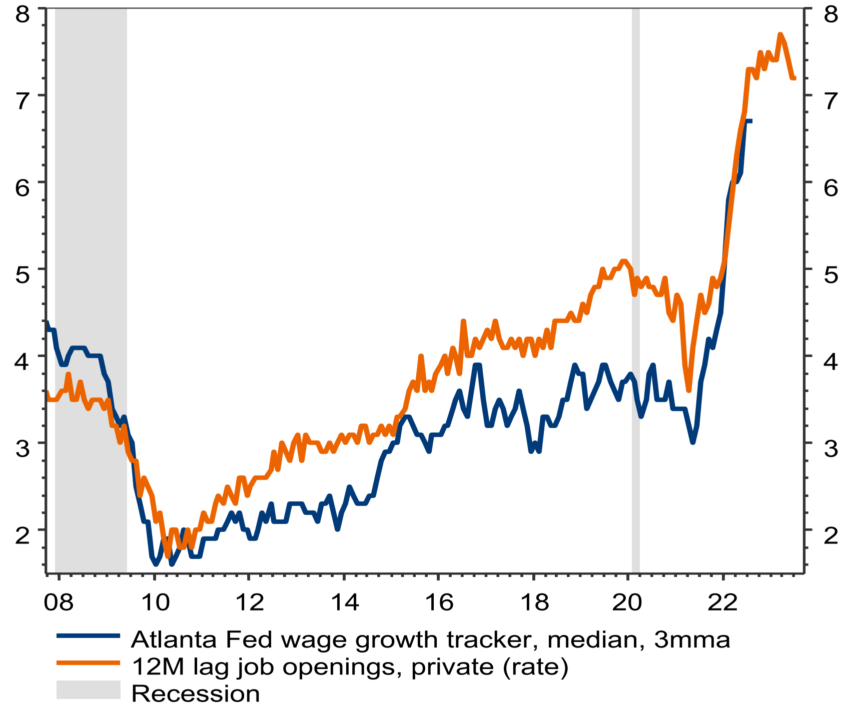
The labor market is still tight, but it is a lagged indicator

Employment still strong, but slowing



Source: BLS

Record labor demand has fueled rapid wage growth, contributing to a wage/price spiral



Source: BLS, Atlanta Fed

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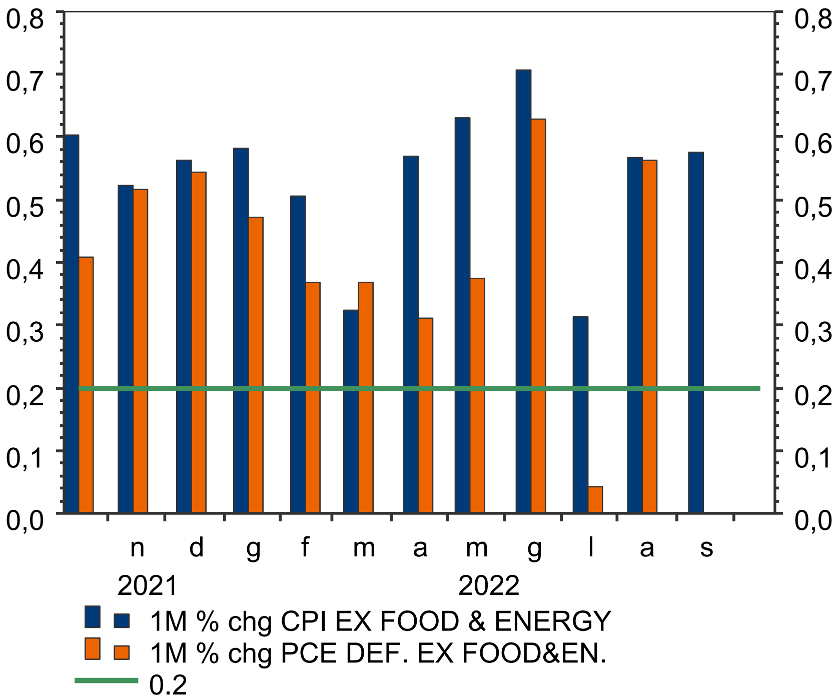
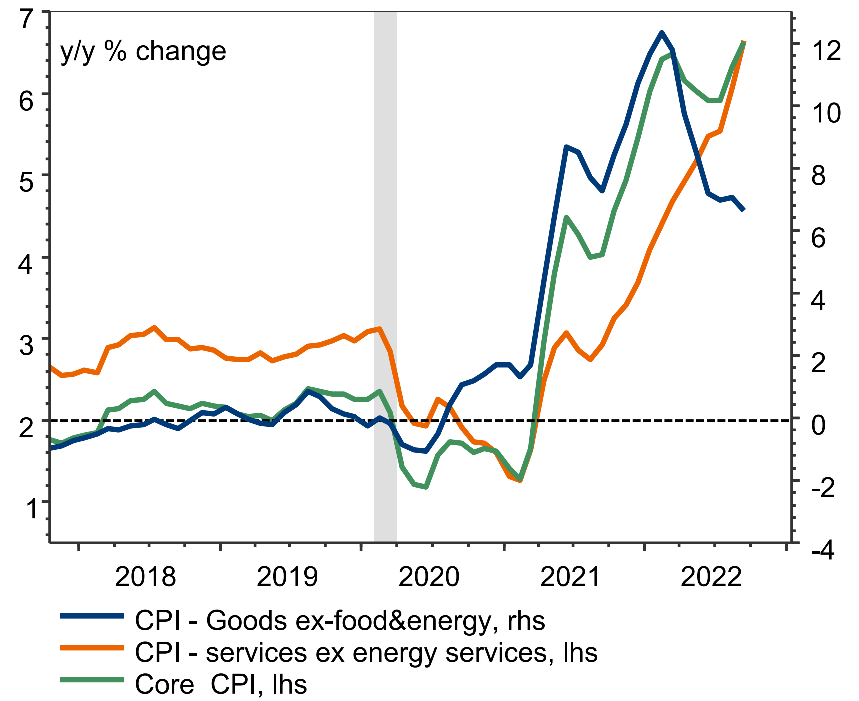
Inflation keeps running and the Fed's chase will end in a recession

Monthly core inflation stubbornly elevated…



Fonte: BLS

…due to ex-energy service prices, while core goods have been on a downward trend since the summer

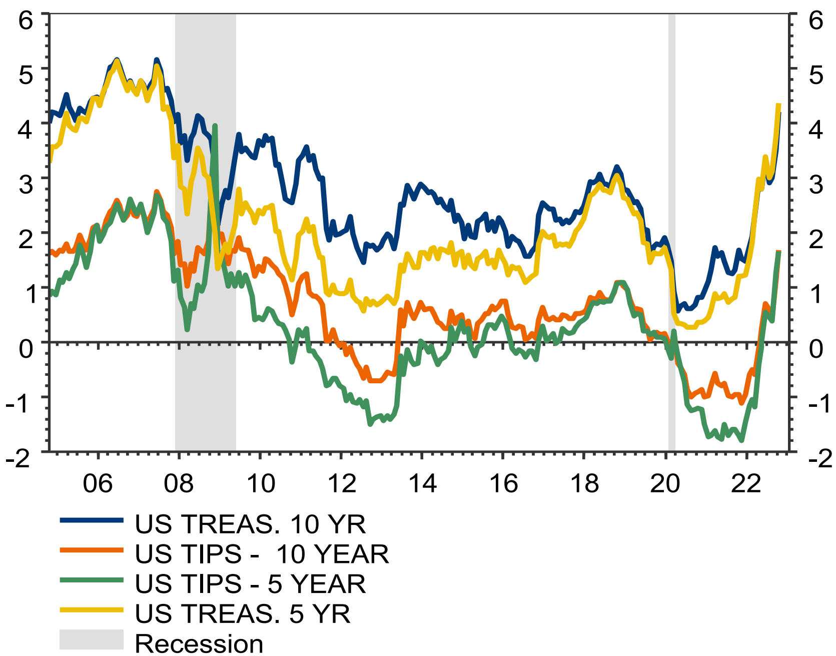


Fonte: Cleveland Fed

The Fed has been frontloading rate hikes since the summer: restrictive monetary policy is here to stay

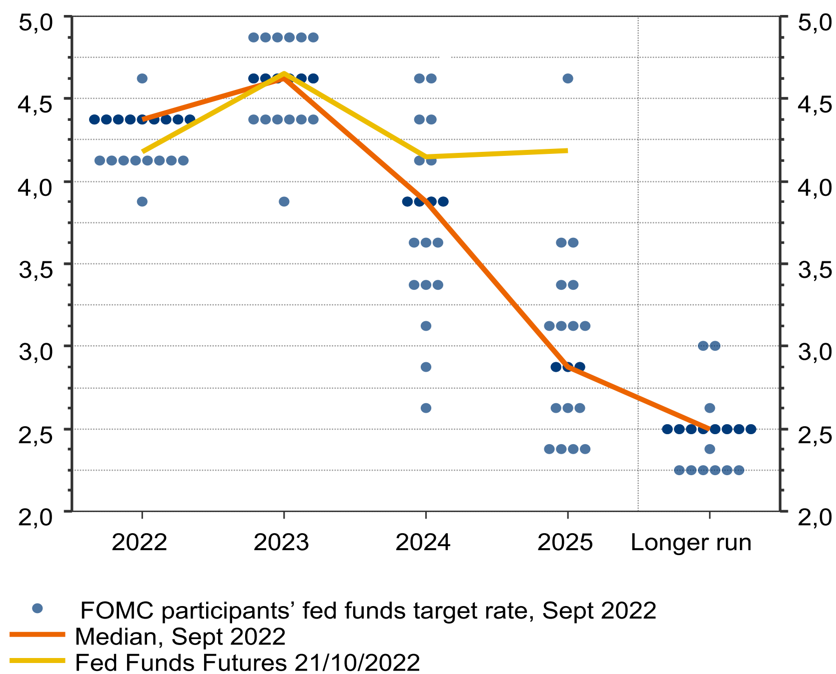
Another **75pb hike is expected in November.** The FOMC will start debating the size of the following actions, as the risks are becoming two-sided. In early 2023 there will be a pause, to assess the effects of the restriction already in place.

The Fed's actions are working: real yields are in restrictive territory, with the risk of excessive tightening



Source: Refinitiv-Datastream

Fed funds rates are expected to be close to 5% in early 2023



Source: Federal Reserve Board, Refinitiv-Datastream

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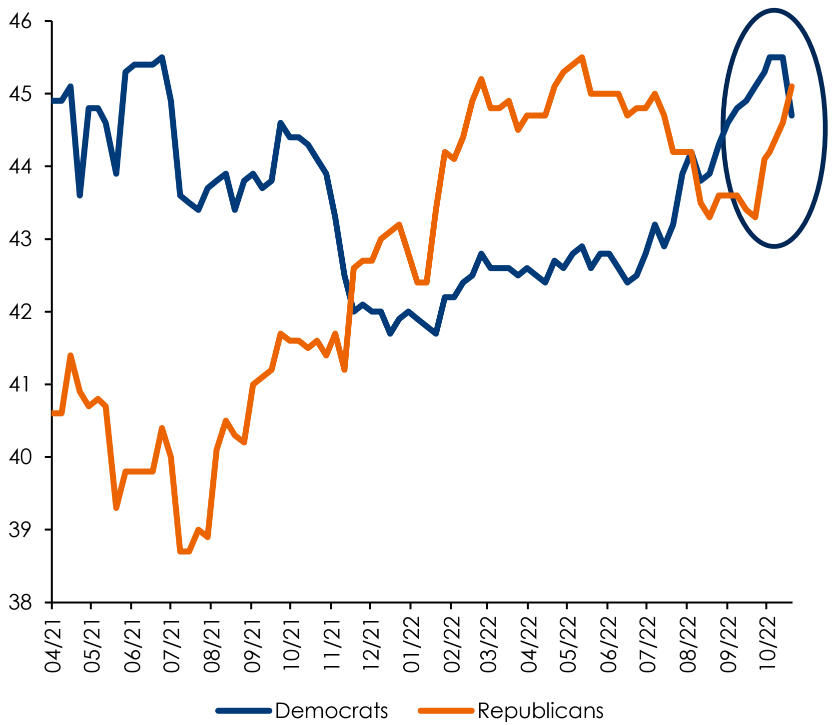
3. **Political outlook: two years of stalemate ahead**

Democrats are going to lose seats in the House, but less than initially feared, and may hold the Senate

- The midterm elections on 8 November should mark the end of the Democrats' full control over Congress and the Presidency, restoring the divided government regime typical of the past decades.
- The **baseline scenario** is a return of the **House to Republican control** with the **Democrats retaining a slim majority in the Senate**. Since the summer, the Democrats' prospects have improved thanks to a number of political and economic successes, that appeared to contain the losses typically incurred by the President's party at the midterm elections.
- Legislative wins in Congress (two bipartisan bills and the Inflation Reduction Act, aimed mostly at healthcare and climate change), lower gasoline prices, the overturning of Roe vs Wade have increased Biden's popularity and strengthened the Democrats' standing. In any case, the chances for a Republican House are almost 100% even without a "red wave". In the past weeks, moreover, Republicans have regained some ground, implying a **very uncertain outcome in the Senate.**

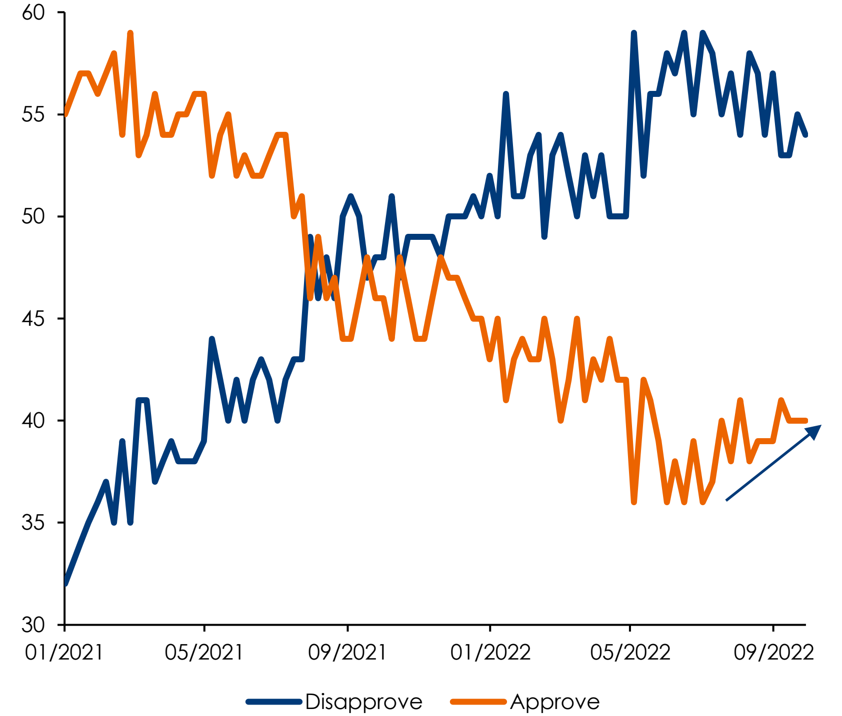
Republicans are back, after a pro-Democrats summer

The Democrats' lead gained in the summer has vanished: Republicans are leading again in generic polls



Source: Fivethirtyeight

Biden's approval has improved since the summer, but will not be enough to save the House



Source: Reuters

Forecasts for the House and the Senate

- **House of Representatives.** The House has 435 seats, renewed every 2 years. A majority requires 218 seats. 31 Democrats and 18 Republicans are retiring, leaving no incumbent. **Central scenario: Republican majority**.
- **Senate.** The Senate has 100 seats, renewed staggered every 6 years, with 1/3 of seats expiring every 2 years. 35 sets up for election, 14 held by Democrats, 21 by Republicans. 1 Democrat and 5 Republicans are retiring. A majority requires 51 seats, in case of a tie the vice president provides the 51st vote. **Central scenario: uncertain,** with a marginal tilt in favor of Democrats.

House: an almost guaranteed Republican majority

Democrats		Republicans		Toss ups
safe dem	168	safe GOP	159	
likely dem	29	likely GOP	15	
leans dem	10	leans GOP	6	
	207		215	13
memo:				
Current House				
Democrats+Ind.	220	Republicans	212	
3 vacant seats				

Source: Fivethirtyeight

Senate: neck and neck, again

Democrats		Republicans		Toss ups
safe dem or not up	45	safe GOP or not up	44	
likely dem	3	likely GOP	2	
leans dem	1	leans GOP	3	
	49		49	2
memo:				
Current Senate				
Democrats+Ind.	50	Republicans	50	

Source: Fivethirtyeight

The political cleavage is likely to widen in 2023-24

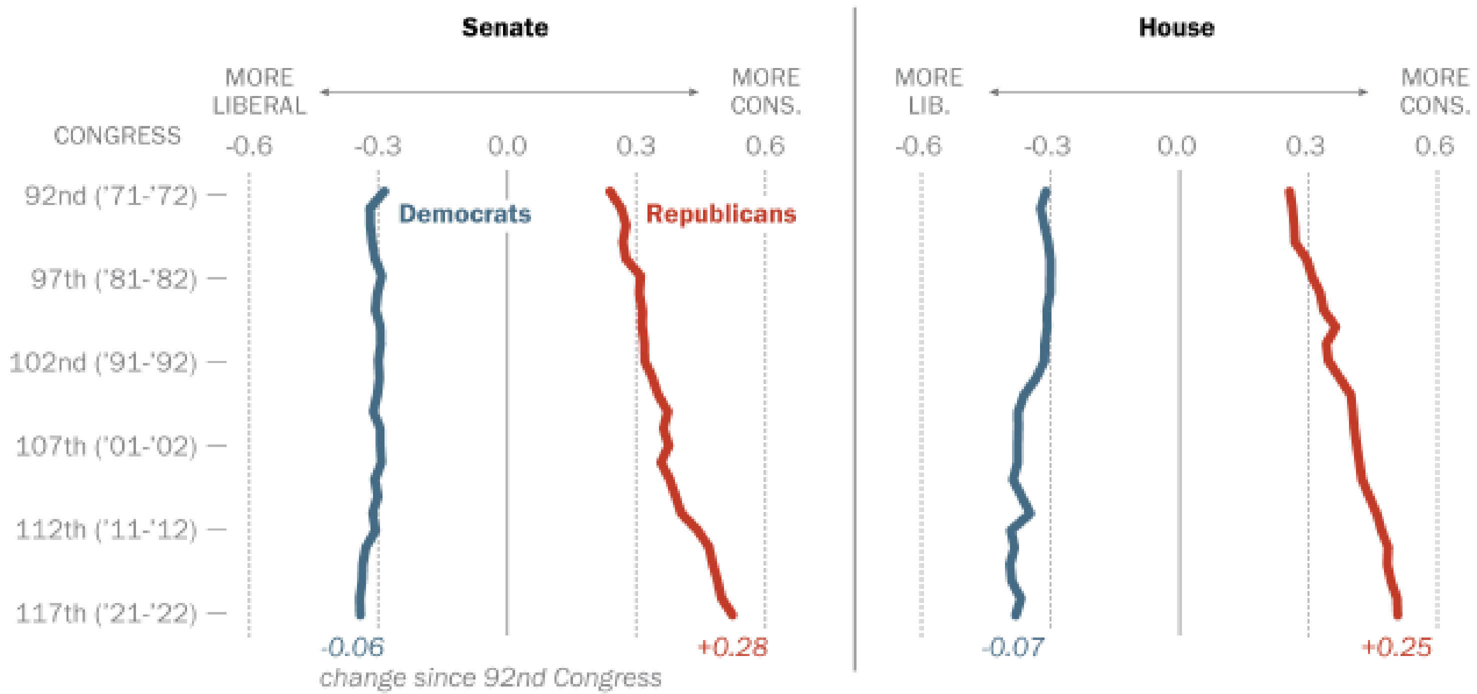
- With only a few weeks to go before the vote, uncertainty on the outcome of the election for the Senate is increasing, leaving a unified Republican Congress as a possibility. Instead, poll data indicate that the probability of the Democrats holding the House is close to zero.

- The end of unified government, with different parties holding the Congress and the Presidency, should usher in a **period of stalemate for economic policy,** likely limited to renewing spending laws and, possibly, extending expiring measures. In case of a split Congress, the political outlook will be particularly divisive, with showdowns on the debt limit and a more pronounced stalemate. Our forecast overall is neutral in terms of fiscal policy, barring new emergencies resulting in bipartisan laws being approved. Biden's action will concentrate on **executive orders,** in the fields of foreign policy, international trade and, possibly, immigration.

- The November result may be more important on the strictly political front, for the judicial appointments if Democrats hold the Senate, and as a signal ahead of the presidential campaign, kicking off in January 2023. See you in 2024!

Polarization keeps rising: a common ground is less likely with every new legislature

Republicans have moved further to the right than Democrats have moved to the left
(average ideology of members, by Congress)



Note: data excludes non voting delegates as well as lawmakers who officially served but (due to illness, resignation or other factors) didn't have a scorable voting record for a given Congress. Party categories include independents who caucus(ed) with that party. Members who changed parties or became independent during a Congress were classiffied according to the status they held the longest during that Congress. For most of th 116 th Congress, Rep. Amash of Michigan was either an independent or a libertarian and didn't caucus with either major party. Source: Pew Research Center.

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