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SPECIAL Market Update

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Midterm Exam

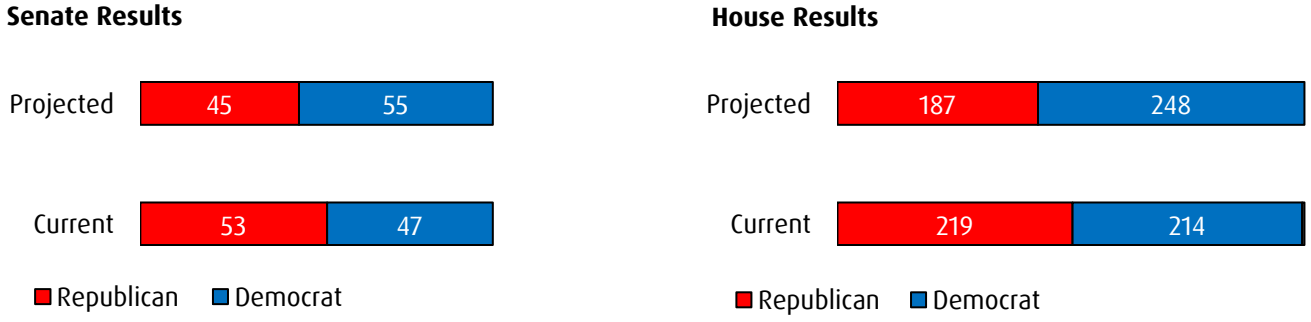
Democrats delivered a decisive victory in Tuesday's midterm elections, capturing both chambers of Congress and gaining more seats – and potentially carrying greater market implications – than investors initially expected. President Trump's conciliatory response reversed an initially negative market reaction – with equity markets trading up over 1%. This reinforced an important investing principle – markets generally value certainty above all else. The Democrat win removes any lingering Fed-independence risks but could complicate fiscal-policy improvements. It may also have medium-term implications for artificial intelligence (AI), trade policy and the Iran conflict – though any Democrat efforts will likely be constrained by both legal and institutional guardrails.

A blue wave election. Tuesday's election delivered a decisive Republican repudiation, with Democrats securing majorities in both the House of Representatives and Senate. While historical precedent always favors the opposition party in midterms, the breadth of Democratic gains exceeded expectations – and offered up some cocktail-party-worthy facts, including: 1.) Democrats won eight of the nine seats expected to shift to the GOP because of redistricting; 2.) A Democrat Senate candidate won in Kansas for the first time since 1932; and 3.) Democrats won a statewide election in Texas for the first time since 1994 – sweeping the governor, lieutenant governor, attorney general and Senate seats. The driving factors behind this blue wave included affordability, elevated energy prices, tariffs and the ongoing conflict with Iran.

Trump acceptance resuscitates equity markets. Financial markets initially responded negatively to the unexpectedly large Democratic victory. S&P 500 futures declined sharply overnight as investors assessed the implications of a more assertive opposition Congress. However, sentiment subsequently reversed as President Trump signaled his willingness to engage with Democratic leadership. At the time of writing, U.S. Large Cap (S&P 500) is up ~1.7% and U.S. Small/Mid Cap (Russell 2500) is up 1.3% – with international developed equity markets (MSCI EAFE) up 2%+. Meanwhile, the 10-year U.S. Treasury yield has moved lower to ~4.91%. The recovery suggests investors quickly moved past the somewhat-expected result and shifted their focus to the potential benefits of political clarity. They are also likely appreciating the benefits of legislative gridlock – in which equity markets have generally fared well, as legislative constraints can reduce the probability of disruptive policy changes. While near-term volatility remains possible, the reversal reinforces the fact that markets are typically more responsive to having clarity on the outcome than the outcome itself.

A new look in Washington D.C. Looking ahead, the midterm results meaningfully shift the political landscape in the final two years of President Trump's term. But, as noted, congressional control does not necessarily translate into policy change. The president retains substantial executive authority – particularly over trade and foreign policy – while the Senate filibuster and presidential veto will make it difficult for Democrats to pass legislation without compromising with at least a faction of Republicans. Nevertheless, the election substantially strengthens Democrats' negotiating position and increases the likelihood of congressional oversight and challenges to administration priorities.

Exhibit 1: A decisive democratic victory
Democrats outperformed expectations, capturing both chambers of Congress by wide margins.



Projected are BWM estimates. Two Senate and 63 House races are not yet called. Senate Democrats include two Independents who caucus with the party.

Did Democrats win a mandate? Possible implications. An important market-outlook question is whether the midterms handed the Democrats a mandate – an answer that will become clearer as all the votes are counted and all the crosstabs are analyzed. If they did (or think they did), it may embolden Democrat congressional leaders to challenge several administration priorities. While there exist notable legislative or legal hurdles to overcome, we could potentially see medium-term market implications across the areas highlighted below:

- **Artificial Intelligence:** Greater scrutiny of data-center development, electricity costs and AI regulation could create headwinds for technology investment – though bipartisan support for U.S. competitiveness should limit sweeping restrictions.
- **Tariffs:** Democrats may seek to constrain presidential trade authority, potentially reducing tariff uncertainty, but any meaningful changes face legal and executive obstacles.
- **Iran:** Congressional oversight and funding restrictions could increase pressure for de-escalation, potentially benefiting energy-sensitive sectors. However, presidential military authority remains substantial.
- **Fiscal Policy:** Fiscal negotiations could become increasingly contentious. Current estimates suggest the statutory debt ceiling could be reached around May 2027 – though Treasury extraordinary measures may be able to prevent payment disruptions until 2028.
- **Monetary Policy:** Democrat control of the Senate effectively gives them veto power over political appointees nominated by President Trump – allowing them to block any less conventional choices for the Federal Reserve's Board of Governors.

One potential risk behind us. We always believed that the midterms were the least concerning of the "big three" risks that have dominated recent investment discussions – the other two being oil/inflation and Fed Policy/interest rates. Despite some knee-jerk volatility, it appears the markets are aligned with our view that the best thing about the midterms is that they are over – and investors now at least have clarity on the composition of the federal government come late-January 2027. We continue to focus on the inflation and monetary-policy risks noted above, while also turning increasing attention to the more-recent risk of potential funding issues within the ongoing AI buildout (with the midterms adding potentially more regulatory risk to this equation as well). Overall, we continue to favor equities over fixed income (although we have moderated that positioning over recent months) and U.S. equities over international markets. We have our regularly scheduled investment policy meetings over the coming week and will be publishing our broader thoughts on the market outlook and recommended tactical portfolio positioning in the November edition of the *Monthly Portfolio Pulse* on November 17.

Index Definitions

U.S. Large Cap: S&P 500® Index is an unmanaged index of large-cap common stocks. **U.S. Small/Mid Cap:** Russell 2500™ Index tracks the performance of approximately 2,500 small to mid-cap companies in the U.S. equity market. **Intl. Dev.:** MSCI EAFE (Europe, Australasia, and Far East) Index is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International.

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