CHIEF INVESTMENT OFFICE

Investment Insights

Midterm Elections 2022: Potential Outcomes and Investment Implications

October 2022

All data, projections and opinions are as of the date of this report and subject to change.

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Data as of October 17, 2022 and subject to change.

The upcoming midterm elections represent a critical checkpoint for the Biden administration and ultimately will set the stage for the prospects of the administration's agenda through the 2024 general election. Although the 2020 election gave Democrats a unified Washington, with control of the White House and effective majorities in both chambers of Congress, the outcome was far from a resounding mandate. Slim majorities and ideological differences within the Democratic Party have led to stalled and slimmed-down legislation. However, with the current partisan tone in Washington, we expect that control of the House and Senate post-midterms will determine the prospects of the Democrats' agenda for the remainder of Biden's term.

The 2020 election was far from the "blue wave" that had been predicted in the months leading up to it. In the House, Democrats lost seats but maintained their majority by a small margin. In the Senate, Democrats took three seats to evenly split the chamber. By virtue of having a Democratic administration in the White House, they currently hold the tie-breaking vote through Vice President Harris. However, Senate filibuster rules require 60 votes to advance most legislation, and moderate Democrats who have pushed back on proposed spending and tax increases (which often may be passed with a simple majority under the budget reconciliation process) have limited the progress of the Democrats' agenda. Now, as we look forward to this November's election, we examine the potential outcomes and how they will influence the next two years in Washington.

Lay of the Land

House of Representatives: As is the case in all biennial midterm elections, all 435 seats of the House will be up for election on November 8, 2022. A simple majority—218 seats—is needed for a party to control the House. Democrats currently hold 220 seats while Republicans currently hold 212 seats. Three seats are currently vacant—two previously held by a Democrat and one by a Republican. Thirty-one Democrats are retiring, leaving no incumbent running for re-election. In this respect, Republicans are less exposed, having only 18 members retiring after their current term ends. Recent polling indicates that there are 190 races falling in the "safe, leans or likely" category for Democrats, while there are 213 races that are "safe, leans or likely" for Republicans. This leaves 32 seats rated as a toss-up: 24 currently held by Democrats compared with only eight held by Republicans.

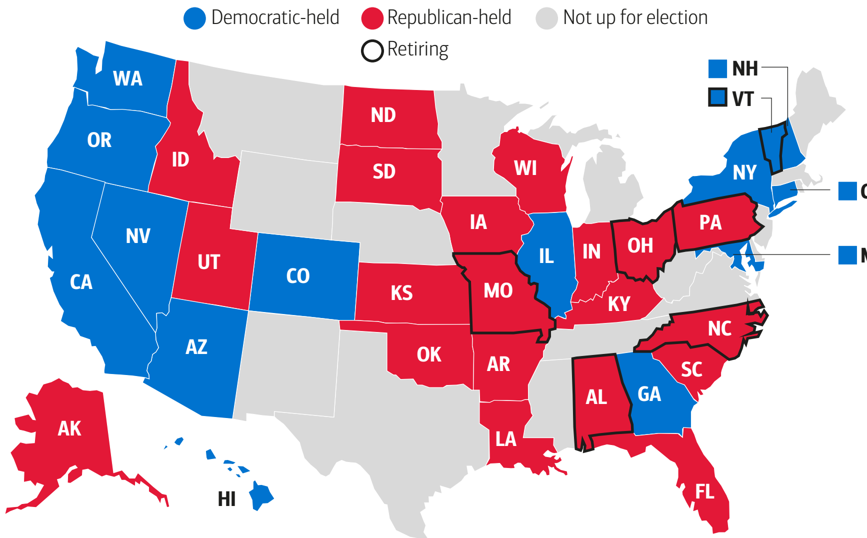
House Outlook: Commentary over the past few months was that the upcoming midterms were expected to be a "wave" or tsunami election in favor of Republicans. Early expectations were a pickup of 40 seats or more due to a variety of factors. One minor factor was redistricting, which is estimated to result in only three additional seats for Republicans. The major reason for the expected success is the fact that a midterm election is historically unkind to the sitting president (the average loss of House seats in a President's first midterm is about 30 seats), and the general view is that the midterm election is a referendum on the president. President Biden's approval ratings—while improving—are near historical lows. At the end of July, the president had an approval rating of 38%—the lowest of any modern president. This has quickly recovered and is hovering in the 43% range. Not good, but better. If we look at past presidents with approval ratings in this range, we see a common thread: All lost a considerable number of House seats, ranging from 26 to 64. Leading up to the 2018 midterms, for instance, former President Trump had approval ratings in the mid 40% range, and the result was Republicans surrendering 40 House seats.

There have been only three instances when the sitting president's party lost fewer than five seats in a midterm election: 1962, 1998 and 2002. In each of those elections, the president's approval rating exceeded 60%. While the improvement in Biden's approval rating over the past month appears to be turning the tide in favor of Democrats, the jump seems to be coming from the Democratic base, not independents (not a good sign for Democrats). The president's approval rating among independents remains a dismal 35%. It's also worth noting that Democrats have seen significant improvements in polling as measured by a generic Congressional ballot of Democrats versus Republicans, but the latest Real Clear Politics average (October 17) still has Democrats trailing by 1.8%. As recently as late spring Republicans had a nearly 5% point advantage on the general poll. The narrowing of the gap is indicative of a shifting public perception of the two parties in favor of Democrats, but is it enough?

All this adds up to high odds that Republicans take control of the House. Some commentators project a 20-plus seat gain by Republicans, while others project a more moderate gain of 10 seats. Either outcome would give Republicans enough seats to take control. Simply put, Republicans don't need a red wave, they only need a red ripple.

Currently, 11 Democratic seats fall into the "safe, leans or likely" Democrat categories, while 19 Republican seats are currently considered "safe, leans or likely" Republican. This leaves five additional seats: (i) three of which are held by Democrats and considered toss-ups: Arizona, Georgia and Nevada; and (ii) two of which are Republican, one being a toss-up (Wisconsin) and the other (Pennsylvania) leaning Democratic. In the toss-up races, a recent trend away from ticket splitting and toward party line voting, could benefit Republican candidates in Arizona and Georgia, which have strong candidates for governor. Similarly, it could benefit Democrats in Wisconsin, which has a stronger (incumbent) governor running for re-election.

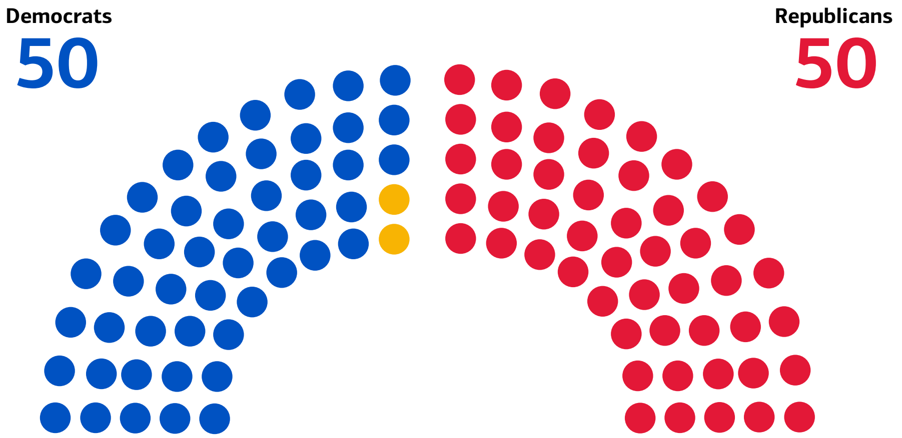
Exhibit 1: 2022 Senate Map.



Source: Washington Post as of September 24, 2021.

United States Senate: The U.S. Senate has 100 members, each of whom serves a six-year term. Unlike the House, terms in the Senate are staggered, with about one-third of seats up for election every 2 years. A simple majority—51 seats—is needed for control, but in the event of an even split (as is currently the case) the Vice President casts the deciding vote, effectively giving control to the Democrats. Thirty-five Senate seats are up for election on November 8, of which 14 are currently held by Democrats and 21 by Republicans. One Democrat, Patrick Leahy (D-VT), is retiring, while Republicans are more exposed, having five retiring after their term ends.

Exhibit 2: Current Balance of Power: United States Senate.



Source: Bloomberg Government as of September 28, 2022. Note: yellow indicates independents who caucus with the Democrats.

Outlook: Not long ago (June 2022), the Democrats' odds of keeping the Senate were just 23%. Fast forward three months, and they hovered around 63% in mid-September. The initial jump occurred at the end of June when the Supreme Court issued the Dobbs' decision, overturning *Roe v. Wade*. They jumped again at the end of August when the bipartisan Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act of 2022 and the partisan 2022 Inflation Reduction Act were passed, proving that legislation can still get done. The abortion issue will likely fade a bit as we get closer to the midterms, since inflation and the economy are more important issues for most Republicans and independents. Declining gasoline prices and former President Trump's return to the headlines due to the Federal Bureau of Investigation (FBI) search and seizure of documents at Mar-a-Lago further aided Democrats. Trump's return to front-page news gave Democrats hope that the election will be less of a referendum on President Biden's first two years and more about a choice: Biden versus Trump (a proxy for Democrats versus Republicans). All of these events have been helpful in improving Biden's approval rating, but questions remain whether the current 43% approval rating versus the 37% lows from this summer is meaningful enough to move the needle in these toss-up Senate races.

While the political winds have shifted in favor of Democrats over the past few months, they are still swirling, shifting and unpredictable. Polls have routinely underestimated Republican support in 2014, 2016 and 2020, and Republicans have usually gained in polling post-Labor Day. Add in the recent sustained September inflation numbers, return of rising gasoline prices, Organization of the Petroleum Exporting Countries+ (OPEC) oil production cuts and Trump fading from the headlines, and the Senate race feels closer to a jump ball, if not a slight tail wind for Republicans. Indeed, this is reflected in betting odds that indicate a Republican controlled Senate surging from 38% in mid-September to 52% in mid-October.

If Democrats gain a seat, it would likely be in Pennsylvania. If Republicans gain a seat, it would likely be in Nevada. This scenario would leave Georgia once again determining control of the Senate. Adding to the uncertainty, there is a possibility that we don't know the outcome of the Georgia Senate race until well after election night. The Georgia race includes a Libertarian candidate, Chase Oliver, who could draw enough votes so that neither the Democrat nor the Republican candidate has over 50%. Like two years ago, that could result in a runoff election between the top two candidates, which would be held on December 6, 2022.

Divided Government

The outcome of the midterms may not only shape the prospects for legislation, it could have additional implications ranging from investment outlook, agency and judicial nominees and the 2024 presidential election.

While the likely outcome of the election is a form of divided government, it is important to note that there are two different forms of divided government. One where both houses of Congress are held by one political party and the White House is held by the other political party (Unified Congress), and the other when the two houses of Congress are held by different political parties, regardless of which party controls the White House (Split Congress). Given current polling, we expect the latter: with the Republicans taking the House and the Democrats retaining the Senate. Despite current polling indicating a Split Congress, it is by no means certain; in fact, recent (October 13) betting odds assign a higher probability (52%) to Republicans controlling both the House and Senate (Unified Congress). With these two indicators showing conflicting outcomes by small margins, both scenarios should be considered.

It is interesting to note that short-term investment returns historically have been best under a Split Congress. The S&P 500 has risen slightly more in the two-year period after Election Day with a Split Congress:

- Average gain over 2 year period 16.9%
- Average gain during a Split Congress 18.7%
- Average gain with unified control 17.3%
- Average gain Unified Congress and opposing party White House 15.7%

Source: Investor's Business Daily as of 2018. This data looks at periods dating back to 1958. Note that these are not annualized returns but the return over a 2-year period; effectively the midterms through the next general election.

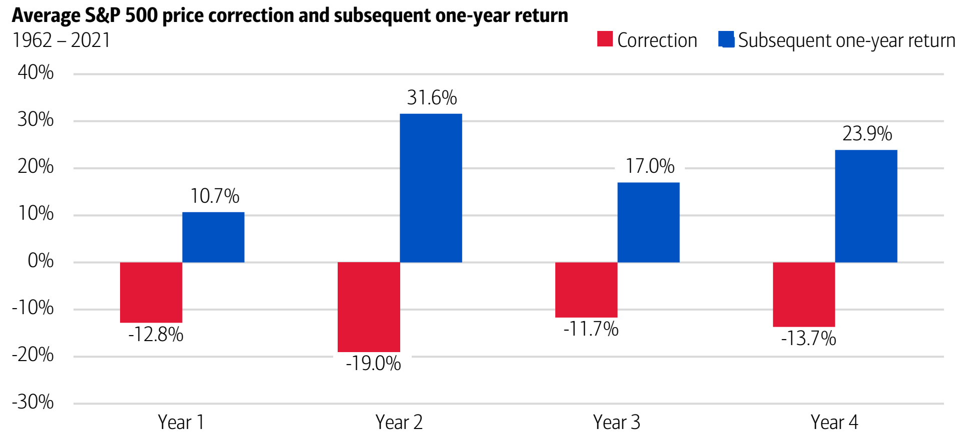
Other Investment Implications

Past midterm election years have tended to feature significant policy-related market volatility and have on average included the largest corrections of any single year in the presidential cycle. Over the past six decades, the average intra-year decline for the S&P 500 in a midterm election year has been 19%, much higher than the typical drawdown in years one, three and four of the cycle (Exhibit 3). One potential factor could be that lawmakers, seeking to retain Congressional power, introduce measures that have popular support but are viewed unfavorably by investors. Recent examples would include the Presidential impeachment in 1998, the Sarbanes-Oxley accounting regulation in 2002, the Dodd-Frank financial regulation in 2010 and new trade protectionism measures in 2018. There have been elements of this pattern in the current cycle, with the S&P 500 falling by well over 20% this year, sanctions imposed on Russia reducing global energy supply, and the Federal Reserve raising interest rates to fight high inflation.

But midterm-year volatility has typically been followed by strong market recoveries, with equity markets up by an average of 32% one year after the midterm election-year low—more than after any other presidential cycle year peak-to-trough (Exhibit 3)—and the

S&P 500 also delivering positive price returns in the 12 months following each midterm election since 1942.

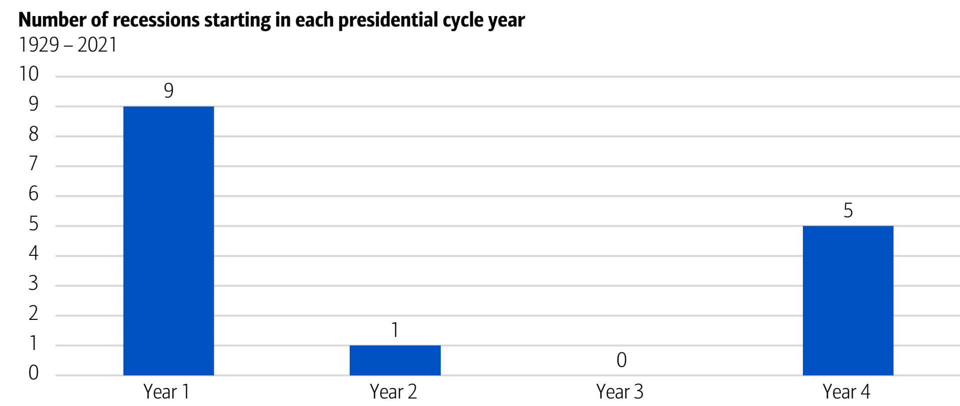
Exhibit 3: Midterm Election Years Have Tended To Produce The Largest Market Corrections and Recoveries.



Source: Strategas Research Partners, Chief Investment Office. Data as of October 14, 2022. **Past performance is no guarantee of future results.**

Just as market-negative policies may partially explain periods of weakness in past midterm years, subsequent strength may be associated with expectations for economic stimulus ahead of the presidential election campaign season. Every cycle is of course different, but these historical patterns will be worth keeping in mind ahead of the upcoming midterms. Given today's backdrop of high single-digit inflation, monetary and fiscal policy are far more constrained than in recent cycles. And indeed the two major instances when stocks did not rally into the midterm elections were in 1974 and 1978, when inflation was also elevated. But even during these periods, equities were nonetheless higher one year after Election Day. One further reason that equity markets have produced positive returns following midterm elections is that year three of the presidential cycle has not produced a recession in any period since 1929 (Exhibit 4). But with monetary policy expected to tighten further over the coming months and signs of weakness already visible in the housing market, recession risks may be higher in the current environment.

Exhibit 4: Recessions Have Historically Not Occurred During Year Three Of The Presidential Cycle.



Source: Strategas Research Partners, Chief Investment Office. Data as of October 14, 2022.

Legislative Outlook

From a legislative perspective, if Democrats retain the Senate but lose the House, we expect an unproductive and divisive 118th Congress. Such an outcome produces the highest odds of stalemate and the highest risk of a disruptive budget event. Of the top four congressional leaders on the scene today, Kevin McCarthy (current Republican House Minority Leader) and Chuck Schumer (current Democratic Senate Majority Leader) are probably the most likely to follow their caucuses if either or both of them wish to go to the brink on the debt ceiling or funding the government. Such an outcome also effectively means Biden's Build Back Better (BBB) Agenda is dead, which means Biden would likely pivot to more executive orders (as did his predecessors). On the heels of those orders, we would expect some court challenges. Unlike legislation, executive orders are not laws.

Republicans as well may not be immune to frustration in a divided government scenario. As current polls suggest, Republicans would probably have a fairly narrow House majority, which will make controlling the chamber especially difficult for likely Speaker Kevin McCarthy. Overall, a Republican House and Democratic Senate will be viewed as less accommodative to new spending (and in turn less inflationary).

Even a unified Republican congress would result in an unproductive Congress. Most bills require a 60-vote threshold in the Senate to avoid a filibuster, and no one is expecting Republicans to attain that level, even with support of a few moderate Democrats. A full Republican Congress would likely have minimal market implications compared with a Split Congress. Under either scenario, the expectation would be for legislative gridlock. Under this scenario, Medicare for All, additional drug price controls, individual and corporate (and global minimum) tax increases, energy taxes, and legislation negatively affecting "sin" industries (prisons and tobacco)—are unlikely. In general a Republican-controlled Congress would be more fiscally restrained (other than defense spending) and would likely lead to less inflationary pressures.

A unified Congress could have implications beyond the next two years. Since the Senate map is favorable to Republicans in 2024, the Senate might not only flip to Republican control for the next two years, but more likely remain that way for the next four years. This would remove the prospect of an all-Democratic government for quite some time.

LAME DUCK SESSION

After the November election, the current congress will continue to be in session even though its successors will have been elected. Until the new Congress' term commences (early January 2023) the current congress will be in a so-called lame duck session. While not much normally gets done in a lame duck session, a shift to Republican control of one or more houses of Congress can incentivize Democrats to strike deals with Republicans.

Government funding expires on December 16, creating the need for must-pass legislation during the lame duck session, and a vehicle for certain discretionary items that can ride along.

What could get done in a divided government?

We believe certain must-pass legislation—continued government funding and raising the debt ceiling—will get done, with potential twists and turns. Beyond that, there are several items that might survive a divided government, but not much beyond these items (some of these items may be addressed in the lame duck session):

- **Trade**: several trade- and foreign policy-related provisions fell out of the China competitiveness legislation (CHIPS Act), including the expiration of the generalized system of preferences (GSP) which provides duty free tariffs on an array of goods. Bipartisan support should provide an easy path to passing legislation in 2023.
- **Taxes**: Prior to 2022, research and development (R&D) expenses could be immediately deducted (for tax purposes) or at the taxpayer's election, amortized over five years. Beginning in 2022, that choice is gone (part of 2017 tax changes), and now R&D expenses must be capitalized and then amortized over 5 years. Without a change, some estimate the effect as equivalent to a 3% corporate tax rate increase.
  - If not changed, various sectors heavily dependent on R&D such as technology, pharmaceutical and defense companies will see the biggest negative effect.
  - There have been bipartisan efforts to change the 2022 rules in the BBB bill, the CHIPS Act and the Inflation Reduction Act, all without success. It is possible, perhaps likely, that lawmakers could reach a deal to delay this change by a year or until 2025 when

many other tax provisions sunset and will be revisited by Congress. There is a chance a deal can be reached in the lame duck session where Democrats agree to extend R&D rules in exchange for extending the expiring enhanced child tax credits for two years.

Throughout 2022, businesses can fully depreciate certain asset purchases for federal tax purposes. This tax benefit begins to phase out in 2023. Restrictions on federal interest deductibility also took place in 2022, which now limits current-year interest deductions to 30% of adjusted taxable income after deducting depreciation and amortization. Prior to 2022, the 30% deduction limit was based on a business's depreciation income without regard to those deductions (essentially earnings before interest, taxes, and amortization). Compromise bipartisan legislation could extend/reinstate the tax benefits, but there is limited Democrat support.

Retirement bills are being considered by the House and Senate, which are not identical but which have many overlapping provisions. A compromise bipartisan version of the bills could come together over the next few months. Such a bill could increase the age to commence mandatory retirement distributions to age 75, increase the contribution limits for older contributors, and require automatic enrollment for certain employers with 401(k) plans, among dozens of other provisions.

- **Same-sex marriage bill**: There is increasing bipartisan support for The Respect for Marriage Act, which would codify the ability for same-sex couples and interracial couples to marry and would require states to recognize the marriages.
  - A vote prior to the midterms would appear to be a political victory for Biden. A vote after the midterm would deny the president such victory. We expect a vote after the midterm elections. Such is politics.
- **Energy permitting bill**: In exchange for Senator Manchin's needed support for the Inflation Reduction Act, Majority Leader Schumer promised to hold a vote on a bill that would expedite the federal permitting process for fossil fuel and renewable energy infrastructure projects. That attempt failed in late September. There appears to be bipartisan support for improving the permitting process, but following Manchin's vote in favor of the partisan Inflation Reduction Act, it is possible that Republicans will withhold their support of Manchin's bill until next year when they anticipate, they will have greater leverage to help shape the bill to their liking.
- **Budget Sequestration**: Automatic budget cuts in excess of $100 billion—known as sequestration—is set to return on January 1, 2023, (as a result of prior deficit increases which violated Pay-As-You-Go (PAYGO rules), which would result in broad-based cuts in many categories of government spending. A compromise was reached last year to delay this result. We expect another compromise, most likely during the lame duck session.
- **Annual National Defense Authorization Bill**: Increases in general defense spending, including additional aid to Ukraine, could be part of a National Defense Authorization bill that receives bipartisan support. Defense authorization bills may also include provisions not directly related to defense spending, so it's possible that some of the legislation discussed above could ride the coattails of this must-pass bill.
- **Hearings and Investigations**: A Republican-controlled House is all but certain to lead to an emphasis on hearings and investigations aimed at Hunter Biden and business deals connected to the president. Additional hearings would likely focus on the end of the Afghanistan war, border security, the FBI, inflation, and, yes, even impeachment.
- **Judicial and Agency Confirmations**: A Republican-controlled Senate is all but certain to create a difficult confirmation process for key Biden judicial and agency nominations. Some prior nominations couldn't even garner moderate Democrat support. With a Republican-controlled Senate, the process will be even more difficult and will further frustrate Biden's priorities.

WHAT COULD GET DONE IN A UNIFIED GOVERNMENT?

While certainly not our base case, and the least likely of election outcomes, if we see a November surprise and Democrats hold the House, they would likely not only hold the Senate too, but increase their number of seats. Such a result could have significant policy implications during the next two years. Democrats would likely revisit some of Biden's social spending originally outlined in his BBB proposals. For instance, paid family leave, universal pre-K and childcare, an enhanced child tax credit, and Medicaid expansion would all be back on the table. All could be viewed as inflationary due to increased spending.

To pay for these programs, Democrats would likely revisit the tax hikes originally outlined in the BBB proposal, which were dropped in 2021-2022 and not picked up in the Inflation Reduction Act. Tax increases on corporate income, multinationals, ordinary income and capital gains (i.e., surcharges) could be back on the table. While taxes and spending were kept in check due to objections by Senators Sinema and Manchin, their concerns could be marginalized if Democrats pick up at least two additional seats.

There also exists the possibility that expanded control of the Senate could mean that Democrats could have the votes to eliminate the filibuster. If that were the case, a simple majority (without a risk of a filibuster) could pass Democratic priorities such as additional climate and labor legislation, including the Protecting the Right to Organize (PRO) Act and a minimum wage hike, and gun control legislation.

Conclusion

With approximately three weeks until the midterm elections, the likely scenarios for control of the House and Senate are taking shape, but there remains plenty of time for the two parties' prospects to change. As recent history has shown, polls can change quickly, and even in the days leading up to the election, they are far from perfect in predicting outcomes. That said, the clear shift in momentum toward Democrats in the past few months has now been replaced by improving Republican prospects. For now, in the House it appears that these shifts may not be enough for Democrats to hold their slim majority and will likely shift control to Republicans but with limited gains. In the Senate, odds seem to have initially flipped in favor of Democrats retaining control but, for the time being, flipped again in favor of Republicans gaining just enough seats to control the upper chamber. This October shift seems to fit the pattern whereby Republicans tend to underpoll and then overperform.

In the coming weeks, a few discreet issues may ultimately determine each party's chances on November 8. Continued worries about the direction of the economy and high inflation will give Republicans a platform to criticize proposed Democratic spending and taxation priorities, which are considered inflationary and incompatible with a slowing economic environment. Meanwhile, concerns over social issues following the overturning of *Roe v. Wade* and former President Trump's return to the headlines may overshadow these economic concerns and continue to bolster the Democrats' outlook as we approach Election Day.

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