MARKET
SIGHT*LINES*

The Midterms: We Are in and Will Remain in Divided Government

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We are in a divided government today, and regardless of the outcome of the upcoming midterms, we're likely to stay there. Why? There's no chance for a super majority in the Senate, and assuming Democrats win either or both houses, President Trump will simply veto legislation he doesn't like. With the election six weeks away, Brian Gardner, Stifel's Chief Washington Policy Strategist, shares his **latest midterm election outlook** – a base case of divided government, with Democrats retaking the House while Republicans hold the Senate. For investors, it can be helpful to focus less on who wins and more on how markets have tended to behave on either side of midterm elections. In this Sight|Lines, we unpack how the election is setting up, how markets behave before and after midterms, on average, and what continued divided government will mean for policy going forward.

THE TAKEAWAY: DIVIDED GOVERNMENT WILL CONTINUE AFTER THE MIDTERMS

With the election six weeks out, our base case is continued divided government. Here we revisit how markets tend to behave through midterm elections. In summary:

- Midterms usually mean a loss of power for the president's party.
- Stifel sees divided government – Democrats retaking the House while Republicans hold the Senate.
- The House is the likelier chamber to change hands, as the margin needed to flip it is small.
- Consistent with historical results, the polling and recent election results point the same way, though redistricting may temper Democrats' gains.
- Fewer Senate seats are being contested, giving Republicans a greater chance of holding it.
- For Republicans to defy history, the election would have to become a referendum on the Democrats rather than the president.
- Looking at markets, equity market volatility tends to run higher and returns tend to lag coming into a midterm, historically these results attributed more to uncertainty rather than policy and these patterns often reverse after the election.
- And, of course, once results are known, focus returns to the policy implications of the results.

IN-DEPTH: THE MIDTERMS APPROACH WITH CONTINUED DIVIDED GOVERNMENT AS THE BASE CASE

The election is six weeks out, and as it approaches, we see little change in the sense that we expect divided government to continue; we also take the opportunity to review again how markets tend to behave through midterms. Going deeper:

- Stifel's Chief Washington Policy Strategist, Brian Gardner, also sees **divided government is the base case**:
  - He sees roughly a 90% chance that Democrats win the House, and a 60% chance Republicans retain the Senate.
  - He sees political uncertainty and investigations ahead, more than a change in legislative or regulatory direction.
- Republicans hold the House 218-214 (three seats are vacant), so only a small shift is needed for a change in control:
  - Assuming the vacant seats go to each one's incumbent party, Democrats need a net gain of three seats to take control.
  - Since World War II the average gain for the party out of power is 25 seats, with only two exceptions – 1998 and 2002 – when presidential approval was over 60%, against 41% today.
- Polling and recent special elections have signaled this likely shift favoring Democrats:
  - Democrats hold a 5.1-point lead in the average generic congressional ballot, and special elections since 2024 have shifted materially in their direction.
  - Gardner expects gains of 10-20 seats, with redistricting and recent court decisions capping the upside.
- The Senate contest is narrower given that only a subset of seats is being contested:
  - Republicans hold the Senate 53-47, so Democrats need a net gain of four seats to gain control.
  - Gardner sees 10 races most influencing the outcome, with Republicans defending seven – Alaska, Iowa, Maine, Nebraska, North Carolina, Ohio, and Texas – and Democrats defending three – Georgia, Michigan, and New Hampshire.
- For Republicans to remain in control, the election would have to become a referendum on the Democrats rather than the president – defying historical patterns – and Gardner has identified two important drivers of such a result:
  - President Trump's approval rating would need to improve further despite gains since its May low, with the race reframed around Democratic socialists more than the president and party in power.
  - Republicans would also need to turn out their base in force — the RNC and allied groups hold roughly an 8-to-1 cash advantage over the DNC, but Gardner remains skeptical given recent Republican turnout in primaries and special elections.
- Our analysis reviews historical market behavior around midterm elections; results have varied and are not indicative of future performance:
  - Historically, volatility and equity returns have differed in the months leading up to midterm elections; the VIX index has averaged 22.8 during the months before a midterm election, higher than average, and the S&P 500 has averaged a year-to-date return of 1.9% heading into the midterms, lower than average.
  - For longer-term investors, historical post-midterm market outcomes have varied: The VIX has tended to fall back to 18.9 and the S&P 500 has posted an average return of 15.4% in the 12 months following a midterm election since 1950.
- As results become known, focus returns to the policy implications of the results and the shape of the new government:
  - With divided government and less legislation, the focus shifts to regulatory agencies and the Federal Reserve, as well as the stronger potential for lengthy government shutdowns.
  - We see increased scrutiny on artificial intelligence, technology, healthcare, energy, defense, cryptocurrencies, and financial services.

WHAT WE THINK

We are in a divided government, and expect to remain so. In our base case, we expect the House to shift to Democratic control and the Senate to likely remain in Republican control, but with narrow majorities in both cases. In the end, we don't expect much in the way of bipartisan legislation. So, we remain focused on policy shifts from the executive branch, the Federal Reserve and the economy. We're focused less on who wins, and more on the evolving market dynamics and where the new government focuses its attention across sectors.

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