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WASHINGTON POLICY STRATEGY

Potomac Perspective

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The ultimate outcome of the elections have yet to be called, but Republicans have a clearer path than Democrats to the House majority. The situation is reversed in the Senate where Democrats have the inside track. The note explains why expectations going into Election Day were wrong and looks at what a Georgia runoff might mean for a year-end spending bill. It also looks at what to expect from the Biden/Xi meeting – light on substance but important optics.

First, to all veterans – thank you for your sacrifice in defense of liberty and freedom and thanks to your families who shared in the sacrifice.

ELECTION STATUS

House

As of this writing, the House has not been called as there are several races, mostly in the West, that have yet to be called. Most of these races are in Arizona, California, Colorado, Nevada, Oregon, and Washington. California is notorious for counting slowly, but few people notice because few races in the state make a difference in the national outcome.

218 seats are needed for the majority. Some trackers have small differences, but currently it appears that Republicans have won 212 seats where the race has been called by a major national media outlet or where the Democrat has conceded. Democrats have won 202 seats where the race has been called by a major national media outlet or where the Republican has conceded. Of the remaining 21 races, Republicans are in a good position to win at least four (would get them to 216). I'll call this Group A. Next, there are around five races (Group B) where trends look good for Republicans, and the Democratic candidate is still a longshot, but has a more plausible pathway than in Group A. Winning two of the five in Group B along with all Group A races would win the House for Republicans. There are three pure toss-ups (Group C). There are four races in Group D that are races where Democrats lead and are favored, but there is still a pathway for the Republican. Democrats are clear favorites in the remaining uncalled races.

We still need to see the final numbers, but while Democrats could conceivably retain the House, Republicans have a clearer path to the House majority than do Democrats.

Possible impact: If Republicans do, in fact win the House, the party will do so with a razor thin majority which will increase the leverage of different factions among House Republicans. Previous notes have warned about the potential of political chaos that could lead to market volatility. Under a scenario of a narrow majority for House Republicans, the GOP could struggle to pass appropriations bills which in turn could lead to government shutdowns. Compromises on the debt ceiling which will likely need to be raised in 2023 could also be difficult to reach. Competing parties and camps will argue who is at fault politically, but for investors, the emerging scenario is a degree of political uncertainty and chaos that might not be adequately priced into markets.

Senate

Of the Senate races called, Republicans have a 49-49 advantage. Democrats have a clear advantage in the two remaining races to retain the Senate and possibly add a seat.

Several media outlets have called Arizona for the Democrat, Senator Mark Kelly, and while that is not a universal call, Kelly is the overwhelming favorite to win.

The Republican in Nevada holds a small lead, but the remaining mail-in votes are likely to come from predominantly Democratic strongholds and are numerous enough to flip the lead. There are also some remaining votes to be counted from rural areas (Republican strongholds), but on net, the final ballots should be enough for the Democrat.

Georgia will go to a run-off and the Democrat, Senator Raphael Warnock, will be the early favorite. Republican Hershel Walker underperformed Governor Brian Kemp and without Kemp on the ballot, Walker is likely to struggle.

The most likely outcome is Democrats increase their Senate majority by one to 51-49.

POST-MORTEM -- WHY WERE PREDICTIONS WRONG?

There are several reasons why Republicans failed to meet expectations and Democrats exceeded them.

First, expectations for a red wave were based more on expectations than on polling. The widely held view was that polls were wrong and were underestimating Republicans. This was the case in 2016 and 2020, but was not the case in 2018. Some pollsters and analysts, like Nate Cohn at *The New York Times*, said they had seen evidence of nonresponse bias in polls, which tends to skew poll results in favor of Democrats. That was not the case this year. Polls were fairly accurate. As an example, the final Real Clear Politics generic poll average was GOP +2.5 -- very close to the final margin.

Second, atypically, Republicans have underperformed their actual national popular vote total in the House. Often, Republicans win more House seats than their national popular vote total. However, it appears that Republicans will win the national popular vote by three or four points, but win barely more than 50% of House seats.

Third, there was a Trump penalty. Candidates endorsed by the former president or who were closely tied to him and invoked his name throughout the campaign underperformed other Republicans. In New Hampshire, Republican Senate candidate Don Bolduc ran 13 points behind non-Trump Republican Governor Chris Sununu and lost. In Ohio, JD Vance, a Trump supporter, won his Senate race, but he ran over 15 points behind Governor Mike DeWine. I mentioned the disparity in Georgia. In Arkansas, former Trump White House Press Secretary Sarah Huckabee Sanders was elected governor but lagged Senator John Boozman by several points. The numbers might vary depending by the state, but this gap is true and observable in state after state. It's also worth noting, it appears that every Republican candidate for secretary of state offices who were 2020 election deniers lost their races. The 2022 midterms should have been a referendum on the incumbent president, but the former president was a factor in key races and hurt numerous Republican candidates.

LAME DUCK IMPLICATIONS

Congress returns to Washington next week to finish several "must do" items including a spending bill. The current Continuing Resolution (CR) expires on December 9. Senate Republicans might be reluctant to sign off on a bill with the runoff pending in Georgia. The GOP will want to keep conservatives in the state engaged. In the House, some conservatives might push the Republican leadership to oppose any bill that the conservatives think increases spending at unacceptable levels. It is

possible that Congress will pass a short-term spending bill that lasts a week or two while negotiations for a longer-term bill continue. Odds of a government shutdown are quite low.

BIDEN/XI MEETING

On Monday, President Joe Biden and Chinese President Xi Jinping will meet in Indonesia. The meeting is an opportunity to cool tensions in a critical region of the world. However, investors should temper expectations for major policy announcements. The Biden administration continues to review the 2018 tariffs placed on Chinese imports. While there could be some modest easing of the tariffs, most tariffs are likely to remain in place, and odds of any announcement during the meeting are low. Even in the absence of concrete actions on economic and trade policies, markets are likely to welcome any talks even if they are mostly a photo opportunity.

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