

Special Coverage:

Undecided election results amid further signs of slowing inflation

Key takeaways

- ◆ As votes in the US midterm elections are being tabulated, the balance of power is still uncertain. There are likely three scenarios: 1) Democrats win the House and Senate; 2) Split Congress as Democrats and Republicans each have a majority in one chamber; and 3) Republicans take control of both the House and Senate. Historically, a gridlock situation has been positive for equities, but the debt ceiling debate could cause some volatility.
- ◆ Headline CPI inflation rose just 0.4% MoM in October (consensus 0.6%), with the YoY rate falling to 7.7% from 8.2%, while core CPI rose just 0.3% MoM in October (consensus 0.5%), with the YoY rate falling to 6.3% from 6.6%. This was the weakest monthly pace since September 2021. Markets are now expecting 'just' 50bp of rate hikes by the Fed in December.
- ◆ Bonds rallied sharply on the news, and we maintain our overweight on investment grade bonds while managing duration. Equities bounced sharply as well but we believe further upside is limited by the fact that slower inflation is a reflection of a slowing growth outlook. We prefer quality companies that generate cash, earnings, and maintain low levels of debt. Interest rate differentials still support the US dollar, especially against EUR and GBP, but the upward momentum may be slowing.



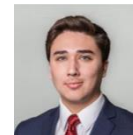
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What happened?

- ◆ Voting for the US midterm elections is over (except in some cases like Georgia where there is a run-off) and while the votes are tabulated and the balance of power is to be determined, US inflation data continue to show a downward trajectory.
- ◆ As of the close on Thursday, November 10, several key election outcomes determining the direction of power have yet to be decided. In the Senate, the Republican Party currently has 49 seats while the Democratic Party has 48. The three final seats to be decided are in Nevada, Arizona, and Georgia. In Georgia, none of the candidates were able to reach majority, which will result in a run-off election in early December between the top two candidates. In Alaska, the electoral process will result in a ranked-choice run-off where candidates will be ranked in order of preference. Given that the two leading vote getters are Republican, it seems likely the Alaska seat could go to the Republican Party. In Nevada, through Thursday afternoon only 88% of the vote was tallied but neither candidate had broached the 50% barrier, suggesting another run-off could be on the horizon.
- ◆ In the House, 26 of the 435 seats have yet to be determined. Republicans picked up a net 16 seats but remain seven seats short of control of the House, where 218 seats is a majority. For the Democratic Party to achieve a majority, they would have to pick up 20 of the remaining 26 seats. Given how tight many of the races have been, it is possible but could be difficult to reach such a disproportionate share of the remaining vote.

Three scenarios that could unfold in the ensuing days (None of these actions or events are certain)

1. Democrats win the House and Senate

- President Biden would likely continue to advocate for his policies protecting the environment, alternative energy, healthcare, and social programs
- Likely reform to be pushed will be on climate change initiatives and healthcare. President Biden said last month that, if Democrats were to win control of Congress, the first bill he would send to Capitol Hill next year would be to codify Roe v Wade, as the 2022 supreme court decision overturned the constitutional right to abortion, nationally
- President Biden could seek to resurrect elements of his Build Back Better agenda, including more climate measures and further expand the social safety net

2. Split congress as Democrats and Republicans each have a majority in one chamber of Congress

- An outcome that historically has been accompanied by positive stock market performance
- Potential rolling back of the Inflation Reduction Act
- Potential roll back of student loan forgiveness
- Potential roll back of corporate tax increases
- Republicans could use a future battle over raising the national debt ceiling as leverage to force cuts in public spending
- Negotiations over spending bills could become quite divisive
- Attempt to lower spending and aid to Ukraine
- Increased potential for more bi-partisan effort on many political issues

3. Republicans take control of both the House and Senate

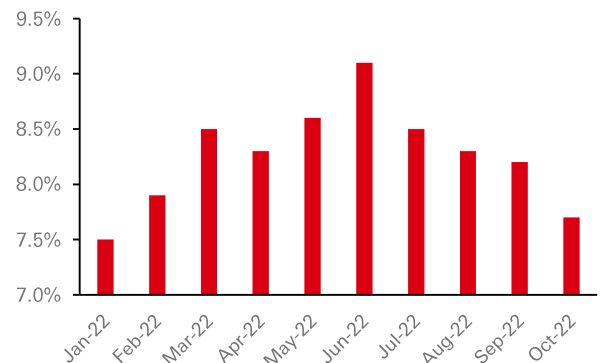
- Likely pressure on internal investigations into President Biden and his family
- Impeachment pressure from GOP
- Strong likelihood of rolling back President Biden's prior initiatives on healthcare, alternative energy, loan forgiveness, and climate change
- Strong likelihood of increased executive actions by President Biden

Inflation is cooling

- ◆ CPI rose 0.4% MoM in October (consensus 0.6%), with the YoY rate falling to 7.7% from 8.2%. Core CPI rose 0.3% MoM in October (consensus 0.5%), with the YoY rate falling to 6.3% from 6.6%. This was the weakest monthly pace since Sep 2021.
- ◆ Motor fuel prices rose 4.0% MoM in October, the first increase in four months. Household energy prices fell 0.5% MoM, led by a 4.6% decline in utility gas service prices. Food prices continued to increase, up 0.6% MoM vs 0.8% MoM, this was the smallest increase in 10 months, but are still up 10.9% YoY (Food away from home rose 0.9% MoM after rising 0.9% in September. Prices are up 8.6% YoY).
- ◆ Key goods that saw lower prices in October included used cars (-2.4%), apparel (-0.7%), furniture and bedding (-1.2%), and household appliances (-0.5%).
- ◆ Rising rents and tight labor market conditions are still putting upward pressure on services inflation. The rent of primary residence index rose 0.7% MoM and the owners' equivalent rent index rose 0.6% MoM in October. YoY both rose 8.7% and 7.7%, respectively. Still strong, but off their highs. Slower rent growth could continue given the moderation in home prices.
- ◆ There was a large decline of 4.0% MoM for the health insurance price index in October. The sharp swing in this index likely reflects a lagged methodological effect from the decline and subsequent rebound in medical care consumption (non COVID-19 physician visits, etc.) that began in 2020. Therefore, the health insurance price index appears likely to switch from an inflation tailwind to an inflation headwind over the next 11 months.
- ◆ The CPI number is welcome news as the Fed is likely still on track to hike rates until there are more signs of a consistent fall in inflation. The CPI number is, however, supportive of our view that we will 'just' get 50bp of rate hikes in December. The market was pricing in a 50/50% chance of 50 or 75bp rate hikes before the number was released, but is now also looking for 50bp only. The Fed will focus on labour market data in particular. We think core inflation can only sustainably come down when labour market demand slows and gets more in line with labour supply.

Inflation is moderating...

CPI YoY % change



Source: Bloomberg, HSBC Global Private Banking as at 10 November 2022.

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